

SUBMISSIONS

Addressing hybrid mismatch arrangements

Submissions received for the Government’s discussion document *Addressing hybrid mismatch arrangements* (September 2016).

Number	Submitter
001	JJL Hoogenboom
002	Andrea Black
003	Olivershaw Limited
004	Chartered Accountants Australia and New Zealand
005	KPMG
006	Westpac New Zealand Limited
007	Fisher & Paykel Healthcare Limited
008	Bank of New Zealand
009	Deloitte
010	Corporate Taxpayers Group
011	ANZ Bank New Zealand Limited
012	ASB Bank Limited
013	Insurance Australia Group Limited
014	New Zealand Bankers Association
015	Russell McVeagh
016	PricewaterhouseCoopers
017	Ernst & Young Limited
018	New Zealand Law Society
019	Baucher Consulting Limited
020	Chapman Tripp (paper submitted to the New Zealand Law Journal)

From: Hoogenboom Family 9(2)(a)
Sent: Thursday, 8 September 2016 14:36
To: Policy Webmaster
Subject: Hybrid mismatch arrangements

Dear Sir/Madame,

A system could be set up where on the yearly basis the amount of GST a company has to pay is set inversely proportional to the amount of local tax this company pays.

With regards

JJL Hoogenboom

9(2)(a)

125 Creswick Terrace
Wellington 6012

Deputy Commissioner, Policy
Inland Revenue
P O Box 2198
Wellington

Addressing hybrid mismatch arrangements

Dear David,

I wish to make a submission in support of the recent release by the Government of the discussion document seeking to counter tax mismatches through the use of hybrid arrangements.

I support the government's moves in this area as the tax reductions possible through their use are, by definition, only available to companies that transact cross-border. As New Zealand's tax policy is heavily guided by a desire to improve efficiency through removing distortions it is the correct thing to do to ensure cross-border activity is not incentivised compared to domestic activity.

It also has fairness or equity benefits because such tax reductions are not available to New Zealand firms operating only in New Zealand.

I wish to commend the policy officials for their work on this paper as - even for tax - it is a technically complex area.

I do, however, wish to make two specific points.

First while I welcome the comprehensiveness of the proposals I am aware that there is significant concern in the tax community about the complexity - particularly in respect of imported mismatches. I am also aware that within its BEPS programme the government still needs to address excess interest limitations and the limitations of the transfer pricing and permanent establishment rules.

With this in mind, if pushing through comprehensive rules creates such an antagonistic environment with the private sector that the other issues would struggle to proceed - I would prefer a less comprehensive approach. From the recent labour hire firm proposals to the staged approach to the 2009 international tax reforms to the limitation of the acting together rule to thin capitalisation and some NRWT structures - a less than comprehensive approach to tax reform is quite usual.

Secondly - as alluded to in paragraph 7.29 - I cannot see any reason why these rules would not apply to trusts with a resident trustee and non-resident settlors - foreign trusts. To the extent that the settlors do not face taxation on any income earned by the trustee this exactly creates the double non-taxation that these proposals are seeking to address. To otherwise exclude foreign trusts from these proposals would only make sense in terms of an unprincipled concession to the foreign trust industry.

I would be happy to discuss either of these points with officials if that would be helpful. I can be contacted on andreataxandyoga@gmail.com.

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28 October 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

Re: Addressing hybrid mismatch arrangements – a Government discussion document (“the DD”)

This is a submission on the above Discussion Document.

Submission 1 Foreign trusts should not be reviewed as part of the review of hybrid instruments

As you are aware the Government established in April 2016 an Inquiry under section 69(3) of the Inquiries Act 2013 constituting one person, Mr John Shewan. The Shewan Inquiry sought and received submissions on its terms of reference which were broad and policy in nature. The Inquiry reported in June 2016 with detailed recommendations which concluded that New Zealand should retain its existing tax laws relating to foreign trusts but ensure adequate information disclosure.

The Government accepted those recommendations. Our first submission is that there should be no additional changes to the tax regime for foreign trusts given the Government’s acceptance of the Shewan Inquiry’s findings. Should the Government now wish to revisit this, there should be a detailed analysis of the Shewan Inquiry and which changes should be made that are inconsistent with that Inquiry.

Para 7.29 of the DD

Paragraph 7.29 of the DD states the following:

There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New

Zealand's right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.

Recommendation 5.2 of the OECD 2015 Final Report "Neutralising the Effects of Hybrid Mismatch Arrangements" (the OECD report") states:

A reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.

A reverse hybrid is defined in recommendation 4 of the OECD report and provides:

A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction.

Submission 2 A foreign trust is not a reverse hybrid

A reverse hybrid is defined in recommendation 4 as stated above. A foreign trust is not transparent for New Zealand tax purposes. Under New Zealand tax legislation, a foreign trust is exempt from New Zealand tax on foreign sourced income. First, this is not transparent, it is not a flow through vehicle. Second, a foreign trust is taxed on New Zealand sourced income. It is not uncommon that a foreign trust has New Zealand sourced income and therefore it has New Zealand tax liabilities. This is clearly not transparent.

Paragraph 7.29 above states that "the trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand's right to tax". As noted immediately above, this is wrong. A foreign trust has both exempt income and taxable income, namely exempt foreign income and taxable New Zealand income. This is not uncommon as many New Zealand entities have both exempt income and taxable income, clearly they should not be considered to be transparent simply due to having exempt income.

For example, New Zealand corporates have exempt income being most dividends received from foreign companies. If a foreign trust is a reverse hybrid, applying the same logic, all New Zealand corporates should also be treated as a reverse hybrid, clearly such an outcome is wrong.

Where a foreign trust earns New Zealand source income, the trustees are taxed on that income.

Given the above, no changes should be made to the existing tax treatment of foreign trusts in New Zealand. The following submissions points are made for completeness as we do not believe a New Zealand foreign trust is a reverse hybrid.

Submission 3 Settlor being part of a control group

As stated in paragraph 7.29, the reverse hybrid rules would only apply where the settlor is in the same control group as the trust. We also note that example 11.1 of the OECD report states the following (emphasis added):

As settlor of the trust, A has the sole right, under the terms of the trust deed, to appoint trustees, which is **one of the enumerated voting rights** described in the related party rules. The fact that the constitutional documents (in this case the trust deed) do not give A the power to authorise distributions or alter the terms of the trust, **does not affect the conclusion that A holds 100% of the voting interests in the trust.**

Voting rights is defined as (recommendation 12 of the OECD report)

Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.

As an initial comment we cannot see how having the right to appoint trustees give voting rights in a trust, let alone how any conclusion can be made that that should be 100% of the voting interests. The above OCED comments are not consistent and demonstrate the issues with this. That is, the voting rights refer to the ability to participate in any decision making concerning a distribution, yet example 11.1 states that with the settlor not having any power to authorise distributions does not affect the conclusion that the settlor holds 100% of the voting interests. Clearly, the trustee(s) has (have) the power to make distributions, and hence it is impossible to conclude that someone who has no such power has 100% of the voting interests.

Further complexities will obviously arise where there more than one settlor or where a/the settlor is deceased. For these reasons we cannot see any viable method of applying the control test to most trusts. While we do not believe trusts are transparent, if they were, we can see no basis for concluding that the trust and settlor are in the same control group and therefore conclude that it is not possible to apply the reverse hybrid rules.

Submission 4 – Applying reverse hybrid based on settlor home country tax jurisdiction rules

The DD concludes “if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person”.

It certainly does not seem logical to tax trustee income if the settlor is not taxed. The settlor may have no beneficial interest in the trust, hence the tax treatment of the settlor seems irrelevant. For example, there will be situations where settlors are deceased. Presumably they are not then taxed. This should not result in the trustee being taxed.

On the face of it, it seems more logical to consider the tax treatment of the beneficiaries as they will ultimately be the taxpayers who will be taxed should any such amounts be taxed. That then raises the issue of which beneficiary? Most foreign trusts will have a number of beneficiaries, most of whom may be discretionary, and many will not know they are beneficiaries. Some beneficiaries will be charitable and therefore exempt from tax.

We conclude that it is simply not possible to tax trustees based on what the tax treatment is of the settlor or/and beneficiaries.

Submission 5 Basis of taxation

The DD by implication seems to conclude that given, the tax treatment of New Zealand foreign trusts, they are reverse hybrid instruments. For the reasons noted above, we do not believe this is correct.

- Foreign trusts will not be hybrid entities if the country that the settlor/beneficiaries reside in is a country which does not tax foreign income (regardless of the nature of the New Zealand foreign trust).
- Foreign trusts that hold equity instruments in foreign operating companies are unlikely to give rise to any tax even if the settlor or beneficiary held those shares directly.
- Many foreign trusts do not earn income (profits are simply derived by companies whose shares are held by the foreign trust), when these companies pay dividends to the foreign trust, the foreign trust may make distributions. Many jurisdictions will tax such distributions. It is difficult to conclude why the foreign trust should be seen as a reverse hybrid in such circumstances.
- Applying New Zealand tax legislation could result in the trustee having NZ taxable income (say under the FDR regime) whereas there is no foreign tax under this basis (i.e. FDR regime) to the beneficiaries or settlor, they are likely to be taxed (if there is taxation) simply on distributions. This is not a reverse hybrid.
- A foreign trust that derives New Zealand source income will be taxable on that income in New Zealand.

Submission 6 Compliance costs

The compliance costs of determining whether the reverse hybrid rules apply are likely to be substantial and in most cases no tax will be payable. We refer to the Shewan Inquiry which concluded that our tax settings are appropriate however improvements should be made to the disclosure regime. We concur with that conclusion and note that this is being progressed by the government. We see no benefit in now applying the reverse hybrid rules, noting that we do not think they should apply in any event.

Conclusion

The proposals in the DD affecting trusts are very unclear to the extent that it is not possible to provide useful detailed technical issues. Our fundamental point is that the New Zealand tax treatment of trusts is to treat them as opaque entities (not transparent entities). On that basis

they should not be hybrid instruments and should be outside the ambit of this review which should be limited to its subject matter – hybrid entities and instruments.

We note a wider concern which is that the DD seems to be extending the ambit of the hybrid review beyond the already very wide ambit adopted by the OECD. This is reflected in paragraph 7.29 with respect to foreign trusts. The OECD report is explicitly limited to what it describes as deductible/ non-income mismatches in the tax treatment of financial instruments (defined as debt, equity or derivatives of debt and/or equity instruments) and to payments under financial transactions. Thus paragraph 11 states:

The hybrid mismatch rules focus on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated Action 2 [the hybrids project].

Paragraph 12 notes that mismatches in tax treatment that are attributable to differences in the measurement of the value of payments rather than the character of the payment, can “generally be ignored for the purposes of the hybrid mismatch rules”. An example given is where one country provides a deduction for foreign exchange fluctuations but the other country does not tax such income.

Example 1.25 gives the example of a lease treated as a finance lease by the lessor (with taxable income only to the extent of deemed interest) and as an operating lease by the lessee (with deductions for all the payments). The conclusion reached is that the hybrid mismatch rules should not apply to such an arrangement because the country treating the instrument as a financial instrument taxes all the deemed interest as income. This is the case even though the lessee obtains deductions exceeding the interest income taxed to the lessor.

It is clear from the above that the OECD report does not intend the hybrid rules to operate so as to tax income or limit deductions just because an entity is tax exempt or exempt on part of its income. It accepts that an entity may get a deduction for equity (deemed interest) that may not be taxable in the hands of an offshore owner. The equity deduction may offset tax on foreign income the entity derives from another party for whom the payment is tax deductible. The report seems to accept that this does not give rise to a tax mismatch that hybrid rules should target. The report notes that a lease may be treated as a finance lease in one country and an operating lease in another giving rise to deductions that exceed the amount returned by the lessor as income but the hybrid rules will not prevent this.

In other words the OECD report is sensibly not attempting to use the hybrid rules to force the harmonisation of the tax rules of every country in the world. The OECD report recognises that the hybrid rules will not prevent international transactions that can result in lower overall tax than might be the case if all transactions were limited to one tax jurisdiction.

In contrast to the OECD position the DD, at least with respect to its comments on foreign trusts in paragraph 7.29, seems to suggest that the hybrid rules should be used to, in effect,

remove any tax exemptions that New Zealand might apply or any New Zealand tax law that might produce an outcome different to that which would apply if the laws of some other country applied. The suggestions in the DD would even subject to New Zealand tax the income of a trust when the country of the settlor and beneficiary would not tax such income and where the country of source does not tax the income. In other words the OECD hybrid report seems to be advanced to support New Zealand tax applying when no tax would ever arise apart from the existence of a New Zealand resident trustee. We see no basis justifying this approach in terms of either New Zealand's interests or the OECD report.

We are happy to discuss our submission.

Yours faithfully

Olivershaw Limited



Robin Oliver MNZM
Director



Mike Shaw CA
Director



28 October 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue
Wellington 6140

Dear David

Addressing hybrid mismatch arrangements

Thank you for the opportunity to comment on the Government discussion document, *Addressing hybrid mismatch arrangements*. We are grateful for the original ten day extension to the deadline for submissions which was notified to us (but please note our comments below in respect of process and timeframe more generally).

We appreciate the Government's desire to address base erosion and profit shifting (BEPS) that occurs via the use of hybrid entities and instruments. New Zealand is part of a globalised economy and needs to consider its policy settings in that context. We acknowledge that New Zealand needs to protect its global reputation by being a 'good global citizen' and that, as a consequence, the Government should consider the effect on other countries of New Zealand's tax policy settings and any changes to those settings.

However, we are not convinced that adopting the OECD's recommendations for addressing hybrid mismatches in the manner and timeframe envisaged is the correct approach. Rather we are concerned that adoption of the OECD's very broad recommendations as set out in the Discussion Document in the implied timeframe of the next two years or less would be to the detriment of New Zealand businesses and the New Zealand economy generally.

New Zealand's national interest

The proposals seem to be us to be inconsistent with the Government's role of protecting New Zealand's national interests and growing the New Zealand economy to maximise the welfare of New Zealanders.

New Zealand is a capital importer and is comparatively highly reliant on foreign direct investment. If the proposals were implemented in their entirety or in large measure we would be concerned that they would increase the effective tax rate on inbound investment and adversely affect New Zealand's competitiveness and productivity. New Zealand competes with many other countries for inbound investors seeking to invest in key commercial and infrastructure projects. Such projects are critical for economic development and tax policy settings must remain competitive to ensure tax does not hinder such investment or raise the cost of that investment so that it becomes infeasible.

In considering whether to adopt the OECD's hybrid recommendations the Government must be very careful to achieve the appropriate balance between doing what is good for the New Zealand economy and protecting the New Zealand tax base. New Zealand's primary focus should not be on protecting the tax bases of other countries.

Importance of other countries' responses

As noted in the discussion document, the United Kingdom and Australia have indicated their intentions to adopt the OECD's hybrid recommendations as has the European Union in respect of intra-EU arrangements. The Discussion Document does not consider the intentions of the United States, Canada, Japan, China and Singapore, for example, which are all significant sources of inbound investment into New Zealand and the home of important trading partners for many New Zealand businesses.

The indicative timeframe (draft legislation in 2017 and application from early 2018) is such that we believe there is a real risk that New Zealand could end up being a leader rather than a follower in terms of adopting the OECD's recommendations. Given that few New Zealand businesses are likely to drive decision-making within corporate groups about group structures and intra-group funding arrangements, it seems inappropriate for New Zealand to be a pioneer or one of the early adopters of the OECD's recommendations. Such decisions are driven by head offices or regional headquarters based in, for example, the United States, Australia or Singapore.

The OECD's hybrid recommendations are premised on their adoption by a number of countries. Generally in a tax context each country is free to determine its own tax policy settings i.e. national sovereignty is paramount. The hybrid proposals are therefore unusual in the sense that they result in the tax treatment in one country being determined or influenced by the tax treatment in another country. In our view the proposals will achieve the OECD's desired outcome only if they are adopted in many OECD / G20 countries if not all. On the evidence so far it seems likely that many countries, OECD member nations and others, will either not adopt the proposals or will adopt them in part only, or will be late adopters.

The risk that the OECD recommendations are not implemented widely must be factored into New Zealand's response to those recommendations. This risk should not be ignored. As Professor of International Tax Law, Juergen Luedicke, noted in his article in the Bulletin for International Taxation:

“Why a state should pioneer the introduction of anti-hybrid rules seems to be a particularly difficult and open question since it is unrealistic that the community of states will achieve a level playing field by introducing harmonised anti hybrid rules. One may well expect at least some states to make a decision not to act if they believe that anti-hybrid rules are apt to put their own industry or inbound investments at a disadvantage.”¹

¹ Bulletin for International Taxation June / July 2014, 300

The Government needs to be cognisant of the fact that implementation of the proposals could result in New Zealand taxpayers being denied deductions because of the tax treatment that applies in another country, which may not have adopted the proposals itself.

We are not suggesting that New Zealand should not be a 'good global tax citizen'. Our concern is that New Zealand becomes a leader despite the country's small size and miniscule share of the global tax base for no other reason than to be seen to be making reforms in line with the OECD's recommendations.

The Government needs to bear in mind that the BEPS project including the hybrids recommendations have been driven by countries with significantly larger economies, which are more attractive because they have significantly larger consumer markets and pools of capital. The solutions offered are primarily designed to assist those economies. The size of those economies means that investment is likely to be 'stickier'. New Zealand's economy does not have the same attractiveness.

It is naïve to assume that New Zealand subsidiaries of multi-national companies will be able to determine or influence the tax treatment of arrangements and financial instruments and changes to that treatment in other countries.

The proposals as part of a broader framework

We welcomed the release of the draft Inbound Investment Framework and the strong signal it sent that any changes to New Zealand's tax rules in response to the OECD's BEPS action plan would be considered in the context of a broader framework that focuses on what is good for the New Zealand economy. We were pleased that the draft Framework made it clear that:

- a Government priority is to ensure that New Zealand continues to be a good place to invest;
- New Zealand's tax system has the overarching goal of maximising the welfare of New Zealanders and the Framework should be seen as part of this system;
- a balance needs to be struck between:
 - ensuring that taxes do not unduly discourage foreign investment or increase the cost of capital for New Zealand businesses, and
 - protecting New Zealand's tax base and preventing tax avoidance;
- any proposals to change current policy settings would be considered within an explicit, robust and coherent economic framework.

The Discussion Document makes no reference to the Inbound Investment Framework. This surprises us given the Framework was intended to be the guiding document against which proposals to counter BEPS in New Zealand would be measured.

Scope and complexity of proposals

The proposals in the Discussion Document are cast very broadly and seem to suggest a fundamental re-think of New Zealand's taxation of inbound and outbound investment. They have implications for many of New Zealand's taxing regimes including the rules that apply to:

- controlled foreign companies
- foreign investment funds
- branches
- thin capitalisation
- withholding taxes
- source and residence
- tax avoidance (New Zealand's general anti-avoidance rule).

The breadth of the proposals is such that they will affect a large number of taxpayers and will have implications for many ordinary business dealings, including, for example, for every taxpayer operating a foreign branch. The potential scope of the proposals is not limited to large multi-national businesses. The proposals will also affect SMEs, partnerships and individual taxpayers.

The Discussion Document does not appear to set out the proposed limits of the hybrid project. Paragraphs 4.7 and 4.8 refer briefly to some of the OECD limitations. In our view the Government should confirm upfront as an underlying principle that the scope of the project is limited to financial arrangements (equity, debt and derivatives) and payments under such instruments. It should confirm that finances leases and any tax exemptions New Zealand may provide in whole or in part are outside the scope of the project.

The proposals are also extremely complex. The Discussion Document is 83 pages and it effectively recommends the adoption of the 450 pages of OECD recommendations. In our view the breath and complexity of the proposals mean that there is a high risk of overreach and collateral damage i.e. a high risk that the proposals will affect genuine commercial transactions that are not the target of the OECD's recommendations. Overreach will create a particular problem if deductions are denied on interest cost necessarily incurred in funding New Zealand business operations.

The complexity of the proposals is such that they also risk creating real uncertainty for taxpayers. Legislative amendments to address hybrid mismatch arrangements should be drafted narrowly and as precisely as possible so that the potential for overreach and collateral damage to commercial arrangements is avoided or at least minimised as far as possible.

As Luedicke states:

“Such countermeasures [anti-hybrid rules] should be drafted as narrowly and precisely as possible based on a proper consideration of situations which do indeed raise policy concerns. It is important to consider that any countermeasure is a deviation from the “normal” system of the tax law based on rules chosen by a sovereign legislator. These rules are generally independent of other states’ laws. Countermeasures need to be drafted in a way which avoids unintended economic or juridical) double taxation. ... They should not punish taxpayers for behaviour which is caused by uncoordinated or deficient legislation.”²

There appears to be an underlying assumption that hybrid instruments are exclusively tax driven so that any overreach or collateral damage can be dismissed. We think this assumption is flawed.

Timeframe and process

A more considered approach will result in a better quality and sustainable outcome, without compromising New Zealand’s ability to achieve appropriate reforms within OECD preferred timeframes. Indeed, the OECD anticipates that countries will need to move at a pace and scope commensurate with their existing tax systems and with legislative and government priorities.

In our view the Government would be better advised to take a targeted approach to addressing hybrid mismatch arrangements. By this we mean an approach whereby any amendments to New Zealand’s domestic tax laws are focused specifically on the use of hybrid entities or instruments in New Zealand that the Government does not believe can be addressed by the existing law including the general anti-avoidance rule.

A more targeted approach would result in law reform that is more relevant to the New Zealand ‘context’. It would also be able to take into account that New Zealand already has robust primary rules including the denial of foreign dividend exemptions for deductible dividends and a powerful and judicially supported general ant-avoidance rule.

A more considered approach would also ensure New Zealand does not become an early adopter or a leader in this context. We understand that Australia has yet to release draft legislation for consultation or introduce a Bill and is unlikely to do so until next year (which, given the Parliamentary process and the Board of Taxation’s recommendation of an application date 6 months after enactment, would suggest a 2019 application date). As a significant portion of New Zealand’s inbound investment is sourced from Australia, it would seem sensible for the Government to wait until Australia’s legislation has been introduced. This would allow the New Zealand legislation to be aligned with Australia’s rules where appropriate.

² Ibid, 310

Part II

Part II of the Discussion Document poses twenty nine questions, almost all of which are open ended. For example:

- 5B “are there any issues with the proposed approach in applying the secondary rule to hybrid dividends?”
- 5D “will this approach to CFC inclusion give rise to any practical difficulties?”
- 5H “are there any issues with providing no exclusion for regulatory capital?”
- 6D “is it appropriate to depart from the OECD’s recommendations in relation to CFC income as dual inclusion income?”
- 9A “are there any issues that may arise in relation to the implementation of Recommendation 7 (dual resident payers) in New Zealand?”

This approach effectively requires taxpayers to anticipate and suggest solutions to any issues arising from the proposals. In our view this analysis should be undertaken by Officials.

A more effective approach would be for the Government, first, to clearly articulate the policy rationale for, and the scope of, the project; secondly, to release more detailed targeted proposals; and, thirdly, to prepare, release and consult on draft legislation. Such an approach would allow the private sector to respond to specific proposals rather than to a set of broad, open-ended questions. It would also ensure that Officials have had the opportunity to turn their minds to the policy rationale for specific amendments, to the practical implications of the proposals in a specifically New Zealand context and to drafting rules that are comprehensible and fit for purpose.

We provide below some comments on Part II of the Discussion Document. In the time available and given the broad manner in which the questions in Part II are posed, our comments are necessarily of a high level only. Once Officials have undertaken further work on developing proposals that address the issues in a New Zealand context more specifically and have released draft legislation, we are likely to be in a better position to comment more fully. In the meantime the comments made below should be considered preliminary only.

Chapter 5: Hybrid financial instruments

Recommendation 2: changes to existing domestic rules

Expansion of section CW 9(2) (c)

We understand the rationale for expanding section CW 9(c) (2) to deny exemption for a dividend which gives rise to tax relief equivalent to a deduction in the payer jurisdiction.

Denial of imputation credits

It seems appropriate for the definition of “segment” to be changed so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign sourced income.

Recommendation 1: linking rules

We consider that the need for a payment deductible in New Zealand under a cross border financial arrangement to be taxed in the hands of a taxpayer of ordinary status within a reasonable period of time fails to fully recognise that hybrid mismatches are often temporary rather than permanent. Any denial of deduction should occur only when the hybrid mismatch has a permanent effect.

Differences in valuation of payments not relevant

We agree that the difference in valuation of payment is not relevant as a foreign currency loan will normally give rise to a foreign currency gain or loss in respect of the loan.

In respect of optional convertible notes in the New Zealand context we suggest that the issue has been settled.

New Zealand financial arrangement rules count foreign currency gains or losses as interest. It is proposed that only the interest component under a hybrid instrument be subject to denial of deduction. This means that any foreign currency gain or loss will need to be excluded. This will add to compliance costs and require changes to some accounting systems.

Timing differences

The Australian Board of Taxation Report has recommended a three year gap between deduction and inclusion of income and payments. Our preference is for the focus to be on permanent mismatches rather than on temporary timing mismatches between deduction and inclusion. This is particularly the case because chapter 11 proposes that withholding tax should continue to apply. This will create double taxation of the same income. It is inconsistent with New Zealand’s approach to the taxation of equity income.

A three year approach, as suggested by the Board of Taxation, may be an acceptable compromise to ensure that shorter timing mismatches are not subject to complex rules. A commercial test, where the loan terms match expected cash-flows, should also be available.

We support the Board of Taxation's carry-forward proposal so double taxation does not occur. We also believe consideration should be given to the UK approach of reasonable, consequential adjustments (carry back adjustments).

There also needs to be the ability to allow for correction of treatments as countries' time frames for implementation of the hybrids recommendations will vary, with some countries unlikely to adopt any or very few of the proposals and others likely to defer adoption for some years.

Taxation under other countries' CFC rules

It is likely to be difficult for New Zealand corporates to establish that a payment is subject to tax in the hands of the payee's owner under a CFC regime. New Zealand entities are often at the 'bottom' of corporate structures and, in many cases, payments made by or to New Zealand corporates will be immaterial to the group's overall position. They will often be unfamiliar with the tax treatments prevailing in the jurisdictions in which other members of the group are located.

However, given the target is D/NI income, if a CFC regime overturns that result, the hybrid rules should not apply. In the absence of a CFC exclusion, the result of the hybrid rules applying would be an ND/T double taxation result.

We are comfortable that the existing onus on taxpayers would mean that only taxpayers who have appropriate systems or material amounts would be able to use this exclusion. The expected difficulty in complying should not prevent those who can comply from benefitting from a principled rule.

Proportion of purchase price treated as payment under a financial arrangement

There is no principled justification for this proposal.

Hybrid transfers

We agree that there should be rules to address share loans or share repos (where the transferor and transferee are both treated as the owner of a financial instrument) that give rise to a hybrid mismatch.

Substitute payment

We agree that, if a substitute payment gives rise to a hybrid mismatch, the hybrid rules should apply subject to any timing rules.

Regulatory capital

Further detailed consideration needs to be given to whether New Zealand should exclude regulatory capital from any hybrid rules it implements. The Australian Board of Taxation highlighted the complexities and interactions involved and recommended further work be undertaken on the issues.

Applying the secondary rule to hybrid dividends

We understand the Government's reasoning for applying the secondary rule to hybrid dividends.

Timing mismatches

We understand the desirability of matching the Australian approach to removing any timing advantages should New Zealand not adopt the same deferral period. This will also depend on the carry back or forward treatments introduced.

Effect of CFC inclusion on application of Recommendation 1

We predict practical difficulties arising where multiple countries are involved with some having hybrid rules and others having no rules or limited rules. Taxpayers will have to bear significant compliance costs.

Taxation of FIF interests

We recommend that FIF interests are excluded from any hybrid rules. Although any rules may only affect FIFs with ownership between 25 and 40 percent (see our comments regarding structured arrangements), the exclusion of dividend income is in effect part of the income calculation. The FDR, cost and DRR methods are proxies for income from a share that in the classic sense is a dividend.

Transfer of assets: revenue account holders

We agree that revenue account holders should be exempt from the rules.

Transfer of assets: hybrid transfers

The recommendation to amend the income tax treatment of New Zealand residents who hold shares subject to a hybrid transfer appears to be a practical response given New Zealand's current rules.

Other exclusions

We consider it desirable that New Zealand gives an exemption to any hybrid rules to which a financial trader is a party. This would be consistent with the UK and Australian proposals.

Applying within New Zealand

We see no policy rationale for applying any hybrid rules to arrangements within New Zealand.

Chapter 6: Disregarded hybrid payments

We are concerned at the uncertainty likely to arise in this area. As noted at paragraph 6.7 of the Discussion Document the question of whether an entity is a hybrid payer will not turn on a preordained list of entities and no characteristics in and of themselves would qualify an entity as a hybrid payer. An entity that is considered a hybrid payer in one scenario may not be a hybrid payer under a different scenario. In our view caution is required before such a broad-brush recommendation is implemented.

Applying carry forward loss rules to carry forward of disallowed deductions

We agree that denied deductions should be able to be carried forward. Applying the current carry forward loss rules to the carrying forward of disallowed deductions is less clearly justified. The effect of the denial is either to treat the deduction as not incurred at that point or as a matching rule with the future income. The principled result seems to be to consider whether there is any net income. As there is not, no taxation should arise.

Dual inclusion income

A simple dual inclusion income approach would be needed to avoid unnecessary complexity and excessive compliance costs.

Carry forward / reversal of defensive rule income

Given the potential for over-taxation in the absence of a carry-forward rule for the application of the defensive rule, we believe it is appropriate to depart from the OECD's recommendations. A reversal rule whereby the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income seems easier to apply than a limitation of the defensive rule.

CFC income as dual inclusion income

Excluding CFC income from dual inclusion income seems appropriate given the likely infrequency of situations in which inclusion is required and the likely complexity of rules to address the issues. However, we note the likely double taxation effect. The ability to exclude CFC income should therefore be considered (in the knowledge that not all taxpayers who might benefit would incur the costs of compliance).

Chapter 7: Reverse hybrids

Recommendation 4

One of the difficulties with Recommendation 4 is that a taxpayer making the payment will require detailed knowledge of the tax treatment of the payment in the hands of the payee. This is likely to be more difficult for extended control groups (beyond parent-subsidary relationships). In addition, to administer these rules, Inland Revenue will need to have a complete understanding of the tax treatment of each payment in each jurisdiction. This seems unlikely.

Recommendation 5.1: CFC rules

We do not believe it is in New Zealand's interest to amend its CFC rules. New Zealand's CFC rules are robust and already meet OECD's best practice. Furthermore, our CFC rules were amended in 2009 to reduce barriers faced by New Zealand companies and encourage businesses with international operations to remain in, establish or expand their offshore activities.

The current CFC rules are extremely complex and impose a compliance and administrative burden on taxpayers. Further amendments to the CFC regime, to impose New Zealand tax on income allocated to a New Zealand resident by a reverse hybrid, will increase the complexity of the rules and the compliance and administrative burden. For some CFCs, financial information may not be available. This could occur when the taxpayer does not control the CFC.

These proposals could inhibit the retention or establishment of New Zealand based multi-national businesses. We note that the Australian Board of Taxation's March 2016 report to the Australian Treasurer recommends that OECD Recommendation 5 not be implemented immediately but that it be left open to implement in the future if integrity concerns arise and after the merits have been given further analysis.

Reverse hybrid entities established in New Zealand

Foreign trusts

First, we do not believe New Zealand foreign trusts should be treated as reverse hybrid entities. Foreign income derived by foreign trusts is exempt, New Zealand foreign trusts are taxed on New Zealand sourced income only. New Zealand taxes trusts (including foreign trusts) as opaque entities. For example, where a foreign trust derives New Zealand source income, the trustee is taxable (not the beneficiaries or settlor). If income is allocated to beneficiaries, the tax liability is on the beneficiaries but that is equivalent to a deduction outside the scope of the hybrid proposals, as per the Discussion Document's own reference (at para 4.7) to the OECD report. If that were not the case, co-operatives would be reverse hybrids. For these reasons alone, foreign trusts should not be classified as reverse hybrid

entities. The fact that New Zealand provides an exemption for the foreign sourced income of foreign trusts is not relevant. The OECD report is clear that the fact that a country provides tax exemptions does not create hybrid mismatches that should be subject to these rules.

In our view it is inappropriate for New Zealand to tax foreign sourced trustee income. The income has no connection with New Zealand apart from the existence of a trustee in New Zealand who has no beneficial interest in the income. New Zealand's current trust regime was established in 1988 and is based on the international model that taxes residents on their worldwide income and non-residents on local income derived from that country. Under this model, non-residents are deliberately not subject to New Zealand tax on their foreign sourced income. The Shewan Inquiry reviewed this outcome and concluded the current tax treatment was appropriate. Applying Recommendation 5.2 to tax trustee income, if it is not taxed to the settlor (assuming a settlor is alive and/or exists) or any other person is unprincipled and changes a fundamental aspect of New Zealand's tax policy settings. From a New Zealand perspective, there has been no erosion of the tax base.

New Zealand branches

It is not clear that New Zealand should implement a rule that would have the effect of taxing income, that under current New Zealand tax rules is not taxable, simply because it is treated by another jurisdiction as attributable to a New Zealand branch and not taxable in that jurisdiction.

As a small capital importing country New Zealand has to balance following the OECD's recommendation and being an attractive place for non-residents to invest.

The Discussion Document appears to fail to consider the recent amendments to the NRWT rules (narrowing of the onshore branch exemption) included in the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill. As a result of the proposed amendments interest income derived by a non-resident with a New Zealand branch will be subject to NRWT unless the money lent is used by the non-resident for the purposes of a business it carries on through its New Zealand branch. If interest income derived by a non-resident is made taxable because New Zealand implements the OECD recommendation to neutralise mismatches caused by differences in the allocation of income between the branch and head office, New Zealand's claim to tax increases to 28%. If that tax increase is passed back to a New Zealand borrower (via a gross-up clause), the New Zealand borrower will suffer an increased cost of funding.

The lack of discussion of the NRWT amendments surprises us. In considering whether to adopt the OECD hybrid recommendations, the Discussion Document should have considered the outcomes for all of the tax regimes including NRWT.

Chapter 8: Deductible hybrid payments

Exemption for active income of foreign branch

If foreign branch losses are not able to be deducted against New Zealand income, there should be a matching active income exemption.

Alternatively, consideration could be given to including a provision that preserves New Zealand tax if a New Zealand corporation has deducted foreign branch losses from its worldwide income and then once it becomes profitable exchanges its branch assets for foreign corporation shares.

Chapter 9: Dual resident payers

Recommendation 7: Dual residents

In our view the Chapter 9 fails to take into account commercial realities. Paragraph 9.3 states: “However, given that dual residence status is in most cases deliberate rather than accidental, it should be possible for taxpayers to be aware of the possibility of double taxation, and by adopting simpler structures, avoid it”.

In our experience “dual residence status” is most often the inevitable result of companies operating cross border where New Zealand statute makes a company resident if either incorporated or managed or controlled from New Zealand. In a trans-Tasman context this inevitably gives rise to dual residence. If New Zealand wants to avoid dual residence of companies it should limit the breadth of our corporate residence test – not punish those who are dual resident as a result of it. As the law now stands a New Zealand incorporated company can unintentionally become a dual resident when New Zealand directors, who manage and control the company, emigrate.

Practical difficulties will arise in identifying dual inclusion income where income is recognised at a later point in time.

Excess amounts disallowed should be able to be carried forward to set off against dual inclusion income in another period.

DTA dual resident rule

Before implementing such a rule, the implications of treating a New Zealand entity as a non-resident need to be fully considered. The effect on New Zealand’s revenue base must be considered. The rule would mean that **all** foreign sourced income derived by a non-resident under a DTA tie-breaker test that breaks the residence to the other country would not be subject to New Zealand tax under New Zealand domestic law. Furthermore, non-resident passive income could be subject to a lower rate of New Zealand tax.

Chapter 10: Imported mismatches

Recommendation 8: Imported mismatch rule

We consider that the imported mismatch rule will impose a significant compliance burden on New Zealand taxpayers (and also on Inland Revenue). As acknowledged at paragraph 10.5 the imported mismatch rule will be complex to apply and will require knowledge of the tax consequences of a wide range of transactions within a group. We strongly disagree that the necessary information will be readily available if a group is structured in a straightforward way and monitors the existence of hybrid mismatches intra-group transactions. Given that most of our major trading partners have not implemented these rules it is unlikely that groups will be monitoring the existence of hybrid mismatches on all intra group transactions.

The imported mismatch rule can apply where a New Zealand borrower makes a payment under a (vanilla) loan, and under another arrangement in the series there is a relevant mismatch which is not counteracted by foreign equivalent provisions.

New Zealand taxpayers will be expected to follow funding arrangements and work out that a mismatch arises in arrangements between third countries. Difficulties in tracing and apportionment are likely. The source and application of funds is not always clear. Taxpayers will need to keep abreast of any law changes in those foreign countries that may change the New Zealand tax treatment. To administer these rules Inland Revenue will need a complete understanding of the respective tax treatment for each entity in a wider chain of entities involved, including aspects that otherwise have no direct effects or consequences from a New Zealand revenue perspective. Based on the OECD recommendations, the imported mismatch rule contains design thresholds which will make the rule extremely difficult to comply with and administer.

Importantly, the imported mismatch rule will breach a fundamental tax policy design principle, namely that the policy is workable for taxpayers and compliance costs are kept to a minimum³.

Further, the fact that this recommendation is being considered undermines the case for adopting the OECD recommendations. Part 1 concludes that global implementation will likely benefit New Zealand. Recommendation 8 assumes the hybrid rules have not been adopted.

CA ANZ strongly recommends that Recommendation 8 is not implemented until a majority of other OECD countries have implemented their own hybrid mismatch rules. If New Zealand implements the hybrid mismatch rule ahead of its trading partners, an unfair compliance burden will fall on New Zealand taxpayers.

³ Recommendation 9 1(h)

Chapter 11: Design principles, introduction and transitional rules

Design principles

At this early stage of proposal development we believe that what is likely to be required is a balance of principles-based drafting, which sets out the policy underpinning the rules, and more precise and prescriptive drafting for issues that require clear boundaries and the provision of certainty to taxpayers. In the absence of more definitive proposals, including draft legislation, it is however, difficult to form a view.

Date of introduction

In our view New Zealand should defer the introduction of anti-hybrid rules until the approach to be adopted in the majority of other OECD and G20 countries is much clearer. Australia and the United Kingdom have progressed further than other OECD / G20 countries but it is important to see how the United States, Canada, Singapore, Japan and other sources of inbound investment also respond. New Zealand should not get ahead of other countries and particularly Australia which we understand has introduced but not enacted legislation.

We note that the Board of Taxation in Australia has recommended that the rules should commence in Australia for payments made on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives the Royal assent. At a minimum New Zealand should not contemplate an effective date until after the Australian legislation has become effective.

Grand-parenting

Existing arrangements have been put in place on the basis of the current rules. Applying very complex new rules to existing arrangements seems unfair and likely to impose high compliance costs. On that basis we suggest arrangements existing at the date of introduction of the new rules in a Bill should be grand-parented. If existing arrangements are not grand-parented New Zealand taxpayers will have to bear the costs of unwinding or restructuring existing arrangements (break costs, advisor fees, foreign exchange adjustments) and the additional funding costs of replacing the arrangements.

We note that the Australian Board of Taxation has not recommended grand-parenting as a general rule but has suggested that, as the legislation is developed, there may be certain categories of arrangements that are identified as appropriate for grand-parenting. This approach seems to leave significant scope for uncertainty but may be fairer as it allows scope for appropriate grand-parenting.

Transitional rules

Given the extremely complex nature of the proposals, and the likelihood that the draft legislation could undergo significant change as it goes through Parliament, transitional rules should be introduced. Again the Australian Board of Taxation did not recommend transitional rules generally but noted that during the legislative design process “it may be identified that particular categories of arrangements require transitional rules” – again an approach that could lead to uncertainty but may be helpful from a fairness perspective.

De minimis rules

In our view de minimis rules can be useful if they minimise the compliance costs imposed on taxpayers. If, however, such rules require taxpayers to undertake complex calculations and analysis to determine whether they can be relied upon, they cease to be useful.

The inclusion of a de minimis rule is likely to be particularly important in the context of the imported mismatch rule, which requires taxpayers to be aware of the tax treatment of different entities and instruments in multiple jurisdictions.

Withholding tax

In our view imposing withholding tax while denying a deduction for a payment would be inequitable. Such an approach would increase the cost of capital if there is a gross up clause, which will generally be the case

Chapter 12: Key definitions

All definitions will need to be clear and unequivocal.

Structured arrangement

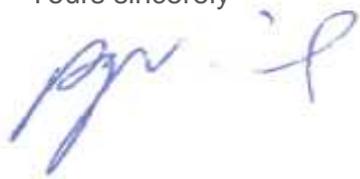
Paragraph 12.7 proposes to amend New Zealand legislation and include a definition of “structured arrangement”. However, we note that paragraph 12.6, which is integral to the definition of “structured arrangement”, will not be incorporated into New Zealand legislation. Paragraph 12.6 sets out the facts and circumstances which should be taken into account in determining whether or not an arrangement has been designed to produce a hybrid mismatch. On its own, paragraph 12.7 is capable of wide application to common investments. (See the FIF paragraphs at 5.41 which raise that possibility.)

We refer to Professor Luedicke’s view quoted at page 4. The anti-hybrid rules should be drafted narrowly and precisely. The proposed definition at 12.7 is neither narrow nor precise.

We recommend that paragraph 12.6 be incorporated into New Zealand legislation.

We are happy to discuss our submissions with you. If you have any questions please contact Teri Welham, Stephen Rutherford or me.

Yours sincerely



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Addressing Hybrid Mismatches
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3 November 2016

Dear Sir/Madam

We welcome the opportunity to respond to the *Addressing Hybrid Mismatches – A Government Discussion Document* ("the DD"). We also appreciate the ability for ongoing constructive dialogue with Officials on this complex area.

Adopting a global programme for New Zealand

We understand and appreciate that the BEPS programme is a global programme. It relies on global implementation. However, the Action 2 recommendations raises the need to balance two competing perspectives.

- Embracing the OECD's recommendations will align New Zealand with some other countries and meet perceived community expectations. This will make New Zealand a good global citizen with a fair tax system.
- Rejecting the OECD recommendations will retain the coherence and sovereignty of New Zealand's tax system and maximise foreign investment in New Zealand.

Both perspectives need to be considered against the fiscal impact of the proposals.

The DD concludes that a comprehensive approach will likely be in New Zealand's national interest. We are not convinced that the case has been sufficiently robustly made. We consider that the DD over-estimates the revenue at risk from failing to adopt the recommendations and the revenue that will be collected as a result of adopting the rules.

We acknowledge that it is possible to reasonably disagree on the balance between the competing perspectives. However, much of what is proposed in the document goes too far, too fast.

We consider that New Zealand should proceed with caution. It should adopt measures clearly in New Zealand's overall interests. This is not to say that there is no need for reform but it should be selective. It should seek to protect existing rules which make sense for New Zealand's tax system. Otherwise, it risks incoherence and reduced revenue and investment.

New Zealand's tax system

New Zealand's tax policy generally follows a principled approach. The Tax Working Group's conclusion that New Zealand's tax system is generally coherent and works well is correct. Disagreements on where the relevant boundaries should be drawn does not change that

conclusion. As they are subject to on-going consultation and review, they are evidence of the good health of the tax system generally.

Generally, New Zealand's tax system:

- Draws the boundary between debt and equity and opaque and transparent entities on a thought out, principled basis;
- Considers company tax as a withholding tax (although that is sometimes conveniently ignored in cross-border scenarios) given the imputation regime;
- Aligns tax rates and systems so that double taxation is minimised;
- Applies a broad based consumption tax; and
- Does not seek to advantage or disadvantage particular behaviours or investments.

Comparing New Zealand with the OECD's programme

Implementation of the BEPS recommendations needs to be carefully considered. The proposals need to be evaluated on a principled basis which is consistent with New Zealand's tax regime. A "New Zealand should adopt it because the OECD has recommended it" approach is not sufficient justification for proceeding and certainly not at speed.

This is particularly the case because the OECD recommendations can be best described as pragmatic. A principled approach would recommend clear debt/equity and opaque/transparent entity borders. It would also limit the potential for double taxation rather than encouraging it.

The OECD recommendations do not specifically take a principled approach. As the DD acknowledges, that is not possible. Instead it recommends tax rules which produce de facto borders and allow double taxation.

Applying the recommendations therefore risks generating incoherent outcomes for the tax system.

The risk factors

This risk is in our view compounded by a number of factors.

Are some of the results in the DD really a hybrid mismatch concern?

The proposals are wide ranging. They question fundamental outcomes of regimes which have been tested through the full generic tax policy process. These regimes achieve what New Zealand wants them to achieve. These are deliberate outcomes.

The proposals will change those outcomes because of decisions made, and not made, by other countries. In some cases with the only apparent justification that the OECD has recommended the rules.

In our view, the results of New Zealand's regimes are defensible from an anti-hybrid mismatch perspective. For example, see the characterisation of the FITC regime referenced in a DD footnote. This shows it is possible to analyse regimes to show they do not provide a hybrid mismatch result. The DD does not appear to do this analysis for any other regimes. New Zealand should consider how its regimes are properly characterised to confirm a hybrid mismatch result and the need for action.

The fiscal impact of the proposals – positive for New Zealand?

The policy justification (in Part 1 of the DD) is that a globally consistent implementation of the proposals will even the global playing field for investment. New Zealand will benefit from a reduced global incentive to use hybrid mismatches. The analysis and justification is brief and qualified. It is focused on “greenfield” investment. It does not appear to consider potential downstream impacts. The net benefits for New Zealand are therefore uncertain.

The analysis assumes the proposals will be neutral or positive for New Zealand’s fiscal position. Hybrid arrangements are assumed to be replaced by equity capital, rather than debt. This assumption needs to be tested, particularly as use of replacement debt may be at higher interest rates.

Cost of capital and compliance costs

New Zealand will generally deny deductions for inbound hybrid financing under the proposals. This will impose additional costs on domestic factors. This includes the substantive loss of tax deductions. It will also require evaluating whether a funding arrangement gives rise to a hybrid mismatch outcome. This will require knowledge of how other countries will tax the arrangement. The compliance costs on borrowers and investors, due to the wide “structured arrangement” definition proposed, should not be underestimated. This is a practical issue.

Other countries’ implementation and approach matters to New Zealand’s position

Most other countries’ tax regimes seek to achieve trade, jobs and fiscal revenue objectives. The BEPS project received political support as, globally, Government revenues were under pressure following the global financial crisis. However, this does not remove the trade and jobs objectives of other countries’ tax regimes. Individual countries will continue to make choices for those, and not just pure tax policy, reasons.

For example, refer the United Kingdom, which has introduced hybrid mismatch rules but at the same time a concessionary “patent box” tax regime to attract technology businesses. The US appears unlikely to adopt any BEPS proposals it considers will adversely impact its multinationals operating globally. (The US Treasury response to the European Commission State Aid Ruling against Ireland is potentially illustrative of its likely position.)

We therefore expect implementation to be inconsistent and ad hoc, based on political economy. Not all major economies will follow suit.

The DD focuses on Australia, the UK and in part the EU. The DD does not explore the reasons why these countries have decided to progress with implementation. Our expectation, based on publicly available information, is they have decided that the hybrid mismatch rules are fiscally positive for them. This suggests fiscal self-interest rather than global co-ordination providing welfare benefits is the driver.

Even for those countries which the DD considers will implement the rules, the DD does not draw the conclusion that New Zealand’s adoption of the rules may be moot. In our view, the New Zealand fiscal position from implementing the rules is much less clear. In fact, our expectation is that the rules may negatively impact the fiscal position.

The DD ignores the position of major investing and trading partners for New Zealand. It therefore does not present a complete picture.

The impact on commercial arrangements

We understand the expectation is that implementation of the proposals will mean there are no hybrid mismatches. The proposals are prophylactic. That may be the case for intra-group structured arrangements which are perceived to have little substance. However, those arrangements appear to already be dealt with by New Zealand’s tax system.

Further, the proposals go beyond such related party arrangements. The DD appears to target every possible mismatch, without properly considering whether a hybrid response is justified. We note specifically the sections which deal with FIF mis-matches as an example. Implementation will therefore affect commercial arrangements.

Full consideration of the consequences cannot be done in the time allowed

Finally, the time allowed for consideration has been insufficient to fully and coherently consider the impact of the proposals. The proposals question the outcomes for many and varied New Zealand tax regimes. In our view, the justification for many of the proposals is lacking.

Further, the flow on consequences do not appear to have been fully considered. For example:

- Is the FIF regime sustainable if the FIF regime is considered to produce hybrid results?
- Will the hybrid rules adversely affect the application of New Zealand's General Anti-Avoidance Rule?
- How do the recommendations overlap so that they can be simplified?
- What opportunities are there to improve New Zealand's rules if the recommendations are implemented?

There is a real sense that this is too far too fast.

Principal recommendation: a phased approach is supported

A better approach would be to consider discrete parts of the Action 2 recommendations by identifying the hybrid arrangements that are most pressing for New Zealand's tax base. This would allow:

- more time to consider the impact and implementation of the remaining recommendations;
- New Zealand to better assess the prospects for other countries to implement the recommendations and therefore the need to implement complex rules with wide application and uncertain effect.

Our recommendation is therefore for a phased approach.

Approach to detailed submissions

These general comments and submissions underlie our detailed comments and observations.

Given the very short timeframe, the breadth of the proposals and uncertainty as to their impact, we have taken the approach of providing detailed comments and responses directly on a word version of the DD. (They are identified by underlining and labelling as **KPMG Comment**.)

We have left the detailed comment section of our submission in draft. This recognises the complexity of the proposals – we may have misunderstood what is being proposed.

We acknowledge the comments may not present a coherent response across the range of recommendations. That is a function of the time available, the range of issues and uncertainty as to what is being proposed and its impact in some cases. Our recommended phased approach will provide a better opportunity to provide a more coherent response.

We trust that our approach encourages continued discussion and makes it easier to match the submission to the proposal.



Inland Revenue

3 November 2016

We would be pleased to discuss our submissions. Please contact John on 04 816 4518.

Yours sincerely

A handwritten signature in blue ink that reads 'John Cantin'.

John Cantin
Partner

Yours sincerely

A handwritten signature in black ink that reads 'D. Elwela'.

Darshana Elwela
National Tax Director

Addressing hybrid mismatch arrangements

A Government discussion document

KPMG Comment and Observations

3rd November 2016

Hon Bill English
Minister of Finance

**Hon Michael
Woodhouse**
Minister of Revenue



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Introduction

Hybrid mismatch arrangements are one of the main base erosion and profit shifting (BEPS) strategies used by some large multinational companies to pay little or no tax anywhere in the world. As such, the OECD has developed recommendations for anti-hybrid measures in its 15 point Base Erosion and Profit Shifting (BEPS) Action Plan.

Hybrid mismatch arrangements exploit the different ways that jurisdictions treat financial instruments and entities to create tax advantages. Because countries have different tax systems, misalignment of domestic rules is inevitable. The OECD recommendations attempt to prevent this misalignment from giving rise to unintended tax advantages. This is primarily done through the use of “linking rules” which change the usual tax treatment of cross-border transactions to ensure that there is no hybrid mismatch in such cases.

Since hybrid mismatch arrangements are not necessarily artificial or contrived, the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches. To achieve this, the proposed rules generally only apply to cross-border transactions involving related parties, as well as unrelated parties if the arrangement has been deliberately structured to produce a hybrid mismatch advantage.

If New Zealand were to adopt the OECD anti-hybrids recommendations, the rules would apply to foreign companies doing business in New Zealand as well as New Zealand-owned companies doing business offshore.

It is expected that most hybrid arrangements would be replaced by more straightforward (non-BEPS) cross-border financing instruments and arrangements following the implementation of the OECD recommendations in New Zealand.

Rules to counteract hybrid mismatch arrangements have been introduced in a number of countries. Notably, Australia and the UK are in the process of implementing the OECD recommendations into their domestic law. In addition, the European Council has issued a directive requiring EU member states to introduce anti-hybrid rules (currently on an intra-EU basis but expected to include arrangements involving non-EU countries in the future).

The purpose of this document is to seek comments on how the OECD recommendations could be implemented in New Zealand. Final policy decisions will only be made after the consultation phase. Part I of the document describes the problem of hybrid mismatch arrangements, the case for responding to the problem, and a summary of the OECD recommendations. Part II of the document explains the OECD recommendations in greater depth and discusses how they could be incorporated into New Zealand law.

Submissions

The Government seeks submissions on how the OECD recommendations should best be incorporated into New Zealand law.

Submissions should include a brief summary of major points and recommendations and should refer to the document's labelled submission points where applicable. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

Submissions should be made by 17 October 2016 and can be emailed to policy.webmaster@ird.govt.nz with "Addressing hybrid mismatch arrangements" in the subject line.

Alternatively, submissions may be addressed to:

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document with key interested parties.

PART I

Policy and principles

CHAPTER 1

Background

Historic focus on the problem of double taxation

- 1.1 The global international tax framework reflected in international tax treaties and countries' domestic tax rules recognises that income earned from cross-border activities is at risk of double taxation – once in the country where it is earned (the source state) and once in the country where the entity deriving the income is resident (the residence state).
- 1.2 Co-operation among countries regarding income taxation has been mostly concerned with this risk of double taxation – when an item of income is taxed under the domestic law of both the source and residence states and its harmful effects on cross-border trade and investment. The principal focus of international tax treaties has been on eliminating double taxation through allocating taxing rights over cross-border income between the residence and source states.

The problem of double non-taxation

- 1.3 Since late 2012, there has been growing awareness that the combination of different domestic tax rules and tax planning allows multinationals to pay little or no tax on their income anywhere in the world, if they choose to do so. This so-called double non-taxation (or less than single taxation) raises a number of tax policy issues. Many of the issues raised, such as distortionary effects and competitive concerns, are similar to those raised by double taxation.
- 1.4 The wide range of international tax planning techniques that are used to achieve double non-taxation are collectively referred to as “base erosion and profit shifting” or “BEPS”. As BEPS strategies take advantage of weaknesses in the current international tax framework and/or gaps or mismatches that result from the interaction of the tax systems of different countries,¹ it is impossible for any single country, acting alone, to fully address the issue. Recognising this, the OECD and G20 have taken the lead on work in this area, with the aim of developing a co-ordinated global approach to addressing BEPS concerns.

KPMG Comment: Paragraphs 1.2 to 1.4 and footnote 1 highlight a fundamental problem with the BEPS project – a failure to agree/achieve consensus on what is the true source of income.

In a hybrid capital mis-matches context this means focusing on the allocation of income for equity and debt.

¹ The issues coalesce such that rules developed to allocate income among countries can be manipulated to shift income away from its “true” source to low tax countries.

Income is generally apportioned between the source and the use of the debt. Income is allocated to where equity is used as no deduction is allowed for the return on equity. Notably, no income is allocated to the country which provides equity capital.

Double taxation arises when there is no deduction for the return on equity and that return is taxed. The standard solution to the double taxation problem is to exempt income from equity in the capital providing country. This allows mis-matches in debt/equity treatment.

The fundamental problem is not the mis-match but the lack of a consensus on the allocation of the “true” source of income from equity. The OECD recommendations deal with this problem by further allocating income to the country where the capital is used.

This creates double taxation, at a minimum at the ultimate shareholder level, but also because it allows company and withholding tax to be applied.

G20/OECD Action Plan

- 1.5 The OECD approach has been to develop specific recommendations for countries to implement, either through changes to their domestic laws, through treaty provisions, or multilaterally. The aim has been to give countries the tools necessary to ensure that profits are taxable, and taxable where the economic activities generating the profits are performed and where value is created. The OECD released an Action Plan on BEPS on 20 July 2013, containing a comprehensive package of measures to address BEPS concerns.² New Zealand has participated in the Action Plan work and supported it, particularly the intention that a co-ordinated global approach be taken to addressing BEPS concerns. The final BEPS package of recommendations was released on 5 October 2015, approved by G20 finance ministers on 9 October 2015, and by G20 leaders during their annual summit on 15–16 November 2015.

KPMG Comment: See our comment on the previous paragraphs.

Hybrid mismatch arrangements

- 1.6 Hybrid mismatch arrangements are identified in the Action Plan as an important source of BEPS concerns. Action 2 of the Action Plan aims to neutralise their effects by developing model treaty provisions and recommendations regarding the design of domestic tax rules.
- 1.7 Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation (including long-term tax deferral) by, for example, creating two deductions for one borrowing or creating a deduction without a corresponding income inclusion. Mostly, the tax result comes from a mismatch of domestic laws, but double tax agreements can be used to enhance the tax benefit by, for

² OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en> (OECD BEPS Action Plan).

example, eliminating or reducing source state withholding taxes. It is often difficult to determine which of the countries involved has lost tax revenue, but there is a reduction of total tax paid.

- 1.8 With many hybrid mismatch arrangements involving New Zealand taxpayers, the exploited mismatch is between New Zealand and Australia's domestic rules. For example, a number of New Zealand taxpayers have been involved in recent tax avoidance litigation with the Commissioner of Inland Revenue (the Commissioner), which concern funding arrangements that exploit the different tax treatment between Australia and New Zealand of optional convertible notes (a hybrid financial instrument) issued by the New Zealand taxpayer to their Australian parent. Similarly, tax disputes have arisen between New Zealand taxpayers and the Commissioner over the tax effects of arrangements that exploit the different ways in which Australia and New Zealand treat Australian limited partnerships.

KPMG Comment: The hybrid mismatch, at least for the OCN, has been countered through New Zealand Court decisions. Officials have previously concluded that those decisions remain effective. (See Officials Report on the benefits of hybrid financing for New Zealand.) This suggests that, at least for this concern, a further domestic response is not required.

OECD recommendations

- 1.9 As part of a first set of deliverables under the Action Plan, the OECD released a paper containing recommendations regarding hybrid mismatch arrangements in September 2014.³ A final report was released in October 2015,⁴ as part of the final BEPS package, containing further work on various remaining technical issues, and additional guidance and practical examples explaining the operation of the recommendations in further detail. The recommendations are for specific improvements to domestic rules to prevent mismatches arising and neutralise their effect, and for changes to the OECD Model Tax Convention⁵ to deal with hybrid entities, and the interaction between domestic rules and the OECD Model. The recommended hybrid mismatch rules are primarily linking rules that seek to align the tax treatment of a hybrid entity or instrument with the tax treatment in the counterparty country, but do not otherwise disturb the commercial outcomes.
- 1.10 New Zealand already has some rules that deter and prevent hybrid mismatch arrangements from arising. However, the OECD recommendations on hybrid mismatch arrangements are comprehensive by comparison.

³ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. <http://dx.doi.org/10.1787/9789264218819-en> (OECD 2014 Interim Report).

⁴ OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241138-en> (OECD 2015 Final Report).

⁵ OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing. http://dx.doi.org/10.1787/mtc_cond-2014-en (OECD Model).

Implementation of OECD recommendations

- 1.11 With the release of the Final Report, along with the Action Plan as a package of recommendations, governments will now look to implement the results into their domestic rules. Although it remains to be seen where different countries will land in terms of implementation, there is an expectation that countries that are part of the consensus will act.
- 1.12 The United Kingdom and Australia have both already committed to implementing the OECD recommendations into their domestic law. In addition, EU member states have been issued a directive to implement anti-hybrid measures for transactions between EU members, with further action on rules applying to non-EU countries expected later this year.

***KPMG Comment:** The document does not address the position of the United States of America. Its position is significant for the global economy and global tax policy. We refer simply to publically available information on the USA's position on EU efforts to counter the "transfer of income from where it is truly sourced" as perceived by the EU but not by the USA. Refer the US Treasury response to the recent European Commission's State Aid decision against Ireland.*

We also note that the EU's position is itself not a settled position. We refer to Ireland's response to the same EU State Aid decision.

In both cases, the response is consistent with our view that BEPS is about trade, jobs and tax policy because most countries will develop tax policy with regard to all three, not just the purity of tax policy. Taking the OECD's position and any particular country's view at face value is risky for New Zealand which traditionally has considered tax policy from a "purer" perspective.

CHAPTER 2

Hybrid mismatch arrangements

2.1 A “hybrid mismatch arrangement”, as defined by the OECD:⁶

... exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax countries to produce a mismatch in tax outcomes where the mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.

KPMG Comment: We note that the definitions proposed in Chapter 12 may, in our view, go beyond arrangements which exploit differences.

We further note that the BEPS project does not acknowledge that domestic tax laws are generally deliberately drawn to achieve tax and other policy outcomes. We acknowledge that while this may not always be true, it should generally be true of countries with mature tax policy development processes.

New Zealand is in our view such a country. It should certainly be true of countries with sophisticated Revenue Authorities. We would count New Zealand and many of its trading partners as qualifying but note this is a subjective analysis. Therefore, where a country has adopted particular parameters such as legal form over substance for debt/equity treatment, these will be the result of specific domestic tax policy decisions.

The hybrid proposals presume these choices give rise to sub-optimal outcomes in need of remedy. However, this is potentially at the cost of fundamentally disrupting the original policy drivers and existing commercial arrangements.

Where sophisticated Revenue Authorities have not been able to have the line legislatively drawn to their satisfaction, a country implementing the OECD recommendations will overrule the other country’s deliberate and in most cases democratically made domestic tax policy decisions.

At Paragraph 1.8 the document refers to the mis-match in Australia’s and New Zealand’s laws. There would be very few who would consider Australia unsophisticated in tax policy terms or in aggressively pursuing its position. To the extent that the OECD report assumes that Australia is unable to look after itself, that is clearly an incorrect assumption. Rather, the mismatch is an outcome of the lack of global consensus on debt/equity and

⁶ OECD 2014 Interim Report at para 41.

entity treatments. The recommendations deal with this problem indirectly and potentially incoherently.

We have taken the use of “exploits” as a pejorative term. It may be intended to be descriptive – that this is an outcome that arises. In that case, where deliberate policy decisions have been made, it is less obvious that a response is required.

2.2 Thus, a taxpayer with activities in more than one country may have opportunities to escape taxation through the use of hybrid mismatch arrangements.

2.3 In the vast majority of cases, the tax outcome comes from a mismatch of domestic laws. However, double tax agreements can be used to enhance a tax benefit (for example, via the elimination or reduction of withholding taxes at source). The use of hybrid mismatch arrangements puts the collective tax base of countries at risk, although it is often difficult to determine which individual country has lost tax revenue under an arrangement.

KPMG Comment: It makes sense for New Zealand to attempt to determine whether it is its revenue which is lost. It appears that the Government has not done the work to make this assessment (see the last sentence of Paragraph 2.3).

If the expectation, that non-hybrid arrangements are used, is realised, we would expect that New Zealand as a net capital importer will raise less revenue. We assume debt with a higher interest rate and not equity will be the replacement funding.

Given that New Zealand may well lose revenue, we consider that work to confirm the revenue position should be done before proceeding.

2.4 Action 2 of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) calls for domestic rules targeting mismatches that rely on a hybrid element to produce the following three tax advantage outcomes:⁷

- *Deduction no inclusion (D/NI):* Payments that give rise to a deduction under the rules of one country but are not included as taxable income for the recipient in another.
- *Double deduction (DD):* Payments that give rise to two deductions for the same payment.
- *Indirect deduction no inclusion (indirect D/NI):* Payments that are deductible under the rules of the payer country and where the income is taxable to the payee, but offset against a deduction under a hybrid mismatch arrangement.

2.5 The mismatches targeted are those arising in the context of payments as opposed to, for example, a mismatch arising from rules that allow a taxpayer “deemed” interest deductions for equity capital.

⁷ OECD 2015 Final Report at para 6.

KPMG Comment: *It is unclear what the implication of this statement is for New Zealand's adoption of the recommendations. Will New Zealand be able to target "deemed" interest deductions for denial of a deduction? This is obviously key to determining whether there is a New Zealand fiscal benefit or not.*

2.6 In broad terms, hybrid mismatch arrangements can be divided into the following categories based on the particular hybrid technique that produces the tax outcome:

- *Hybrid instruments* exploit a conflict in the tax treatment of an instrument in two or more countries. These arrangements can use:
 - *Hybrid financial instruments*, under which taxpayers take mutually incompatible positions regarding the treatment of the same payment under the instrument;
 - *Hybrid transfers*, under which taxpayers take mutually incompatible positions regarding who has the ownership rights in an asset; or
 - *Substitute payments*, under which a taxable payment in effect becomes non-taxable by virtue of a transfer of the instrument giving rise to it.
- *Hybrid entities* exploit a difference in the tax treatment of an entity in two or more countries (generally a conflict between transparency and opacity).

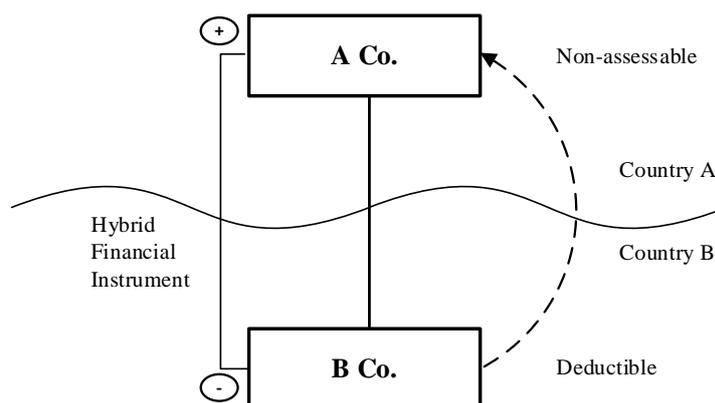
2.7 Hybrid entities and instruments can be embedded in a wider arrangement or structure to produce indirect D/NI outcomes.

Hybrid instruments

Hybrid financial instruments

2.8 A simple arrangement involving the use of a hybrid financial instrument is set out below.

Figure 2.1: Hybrid financial instrument⁸



- 2.9 Under the arrangement, B Co (resident in Country B) issues a hybrid financial instrument to its parent A Co (resident in Country A). Country B treats the instrument as debt, so that payments under the instrument are treated as deductible interest to B Co. Country A treats the instrument as equity, so that payments under the instrument are treated as exempt dividends (or otherwise tax relieved) to A Co. The tax outcome is D/N.I.
- 2.10 A number of New Zealand taxpayers have had recent involvement in tax avoidance litigation with the Commissioner of Inland Revenue regarding their use of hybrid financial instruments in funding arrangements with their offshore parents.
- 2.11 In *Alesco New Zealand Ltd v Commissioner of Inland Revenue*,⁹ the New Zealand Court of Appeal considered one such arrangement as a test case. The New Zealand taxpayer had issued optional convertible notes to its Australian parent; treated as part debt and part equity in New Zealand, but exclusively equity in Australia. Outside of tax avoidance, the tax outcome was D/N.I: a New Zealand deduction for the interest notionally paid by the New Zealand taxpayer on the debt component of the notes,¹⁰ but no interest income to the Australian parent for which it would otherwise have been liable for Australian taxation. The Court of Appeal’s holding that the arrangement was tax avoidance was not based on the Australian tax treatment.

KPMG Comment: *The document does not consider the effect of alternative funding and its effect on New Zealand’s tax revenue. The Alesco OCN would seem to be a good case study. In that case, Alesco argued that the counterfactual – use of vanilla debt – would have resulted in the same or lesser tax outcomes for New Zealand.*

We note that Officials appear to be of the view that equity funding will replace hybrid debt funding. This is supported by analysis which says that debt funding into NZ is typically less than the safe harbour thin capitalisation rules. That is not unexpected. Additional debt is not

⁸ OECD 2014 Interim Report at p33.

⁹ *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

¹⁰ With no New Zealand non-resident withholding tax (NRWT) liability.

readily introduced into New Zealand after the initial investment. Over time, the debt level can be expected to decrease as a percentage.

However, our experience is that debt levels, at the time of investment, will approach the thin capitalisation safe harbour rate. The effect of New Zealand tax on the marginal investment has been the focus of tax policy. We consider debt, and not capital funding, is the better comparator. Simple debt is likely to attract higher interest and also higher cash outflows from New Zealand. This is likely to lead to both lower fiscal revenue and also lower capital retained in New Zealand.

- 2.12 Apart from taxpayers formally bound by the *Alesco* ruling, a number of New Zealand taxpayers have, in recent times, entered into arrangements under which they have issued mandatory convertible notes (MCNs) to their offshore parents. Commonly, interest is accrued over the term of the arrangement, and at maturity, the issuer's interest obligation is satisfied by issuing shares. As New Zealand treats the MCN as debt, the arrangement gives rise to deductible interest to the New Zealand issuer,¹¹ but the issue of shares to satisfy the New Zealand issuer's interest obligation does not result in income to the offshore parent (that is, D/NI).
- 2.13 The Commissioner has challenged a number of the arrangements using MCNs as tax avoidance arrangements. Under recent Australian domestic rule changes, a D/NI outcome can potentially now be achieved using an MCN with cash interest payments. Previously, Australia's non-portfolio foreign dividend exemption would not have applied had cash interest (rather than the issue of shares) been paid under the MCN, because an MCN is not legal form equity.¹² Now, such payments would likely be exempt in Australia;¹³ the amendments ensure that Australia's non-portfolio foreign dividend exemption applies to returns on instruments that are legal form debt but that Australia characterises as equity, as a matter of substance, under its debt-equity rules.¹⁴

KPMG Comment: *See our comments at Paragraph 2.11.*

- 2.14 A third common form of trans-Tasman hybrid financial instrument is frankable/deductible instruments issued by the New Zealand branch of some Australian banks to the Australian public.¹⁵ Typically, these instruments qualify as bank capital for Australian regulatory purposes. As with the MCNs, the bank issuer claims a New Zealand tax deduction for the coupon on these instruments. The Australian tax treatment is different. The instruments are treated as equity for Australian tax purposes, but because they are held by portfolio investors, the return is taxable. However, the bank attaches franking credits to the coupon. The credits work in the same way as New Zealand imputation credits. The credits are not generated by the investment of the funds raised by issue of the

¹¹ And no New Zealand NRWT obligation. ***KPMG Comment:*** *It is not clear why this result is obtained, the issue of shares to satisfy the interest would appear to still be interest (albeit it is not in cash).*

¹² Section 23AJ of the Australian Income Tax Assessment Act 1936 – repealed under item 1 of Part 1, Schedule 2 to the Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014.

¹³ Although *prima facie* subject to New Zealand non-resident withholding tax. ***KPMG Comment:*** *It is not clear why the two qualifications are included, i.e. "Although prima facie...?"*

¹⁴ The Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014 received Royal assent on 16 October 2014. The relevant provisions apply the day after Royal assent: section 2 and Part 4 of Schedule 2.

¹⁵ See *Mills v Commissioner of Taxation* [2012] HCA 51.

instruments – because that income is earned by the New Zealand branch of the Australian bank it is not subject to Australian income tax. So the Australian bank obtains a New Zealand income tax deduction for a payment which for Australian tax purposes is treated in the hands of the payee as made out of fully (Australian) taxed income.

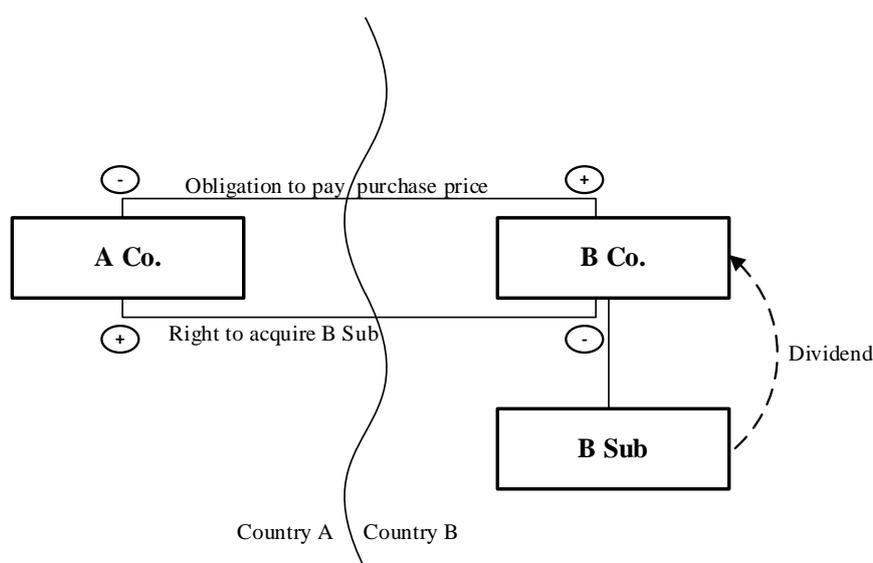
- 2.15 This type of instrument is considered in Example 2.1 of the Final Report, which concludes that it gives rise to a hybrid mismatch.

KPMG Comment: See our comments at Paragraph 2.11. Further, such instruments would typically reduce the interest rate by the franking credits attached. This, by definition, means that New Zealand will lose revenue from any replacement debt financing. (We would not expect such a branch to be capital funded in New Zealand. Capital funding would be raised outside New Zealand so that franking credits can be attached.)

Hybrid transfers

- 2.16 A simplified arrangement involving a hybrid transfer is set out in Figure 2.2.
- 2.17 Typically, a hybrid transfer is a collateralised loan arrangement or share lending transaction where the counterparties in different countries are each treated for tax purposes as the owner of the loan collateral or subject matter of the share loan. In the arrangement set out in the figure below, the mismatch arises because Country A taxes the arrangement in accordance with its economic substance (a loan with the shares as collateral), while Country B (like New Zealand) taxes in accordance with the arrangement’s legal form (a sale and repurchase or “repo” of the shares).

Figure 2.2: Hybrid transfer – share repo¹⁶



- 2.18 A Co (resident in Country A) owns B Sub (resident in Country B). A Co sells its B Sub shares to B Co under an arrangement that A Co will reacquire those

¹⁶ OECD 2014 Interim Report at p35.

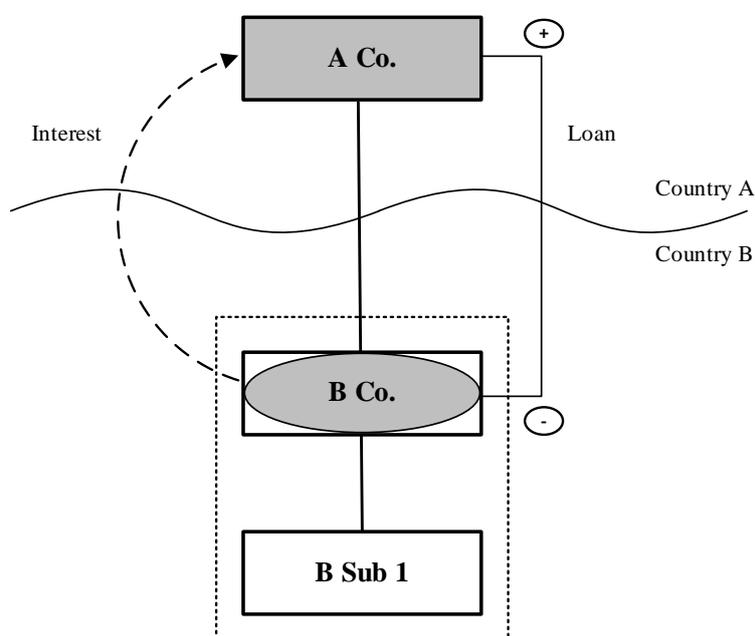
shares at a future date for an agreed price reflecting an interest charge reduced by any dividends B Co receives on the B Sub shares. Between sale and repurchase, B Sub pays dividends on the shares to B Co. In Country A, A Co is treated as receiving these dividends and paying them to B Co as a deductible financing cost. In Country B, B Co is treated as receiving the dividends, which are tax exempt. The tax effect is D/NL.

Hybrid entities

Disregarded payments made by a hybrid payer

- 2.19 A simplified arrangement involving the use of a hybrid entity to achieve a D/NL outcome is set out in Figure 2.3.

Figure 2.3: Disregarded payments made by a hybrid entity¹⁷



- 2.20 A Co (resident in Country A) indirectly holds B Sub 1 (resident in Country B) through B Co, a hybrid entity treated as transparent in Country A, but opaque in Country B. B Co borrows from A Co, and pays interest on the loan, which is treated as deductible in Country B. The deduction can be used to offset income in B Sub 1's group of companies in Country B. As Country A treats B Co as transparent (and as A Co is the only shareholder in B Co), the loan, and interest on the loan, between A Co and B Co, is disregarded in Country A (that is, a D/NL result).¹⁸
- 2.21 New Zealand unlimited liability companies are used to play the role of B Co in the figure above to achieve a D/NL (inbound) outcome. The United States'

¹⁷ OECD 2014 Interim Report at p42. The tax outcomes of the arrangement are described at paras 73–74. This structure is also at the core of Example 3.1 of the OECD 2015 Final Report at p288.

¹⁸ The treaty implications relate to whether, and to what extent, Countries A and B are limited by the relevant treaty in taxing the income of A Co. Under the OECD Model, an amount arising in Country B is paid to a resident of Country A, so, *prima facie*, the benefits of Article 11 (Interest) would be granted.

domestic “check the box” rules allow a New Zealand unlimited liability company, treated as opaque by New Zealand, to be treated as transparent for United States income tax.

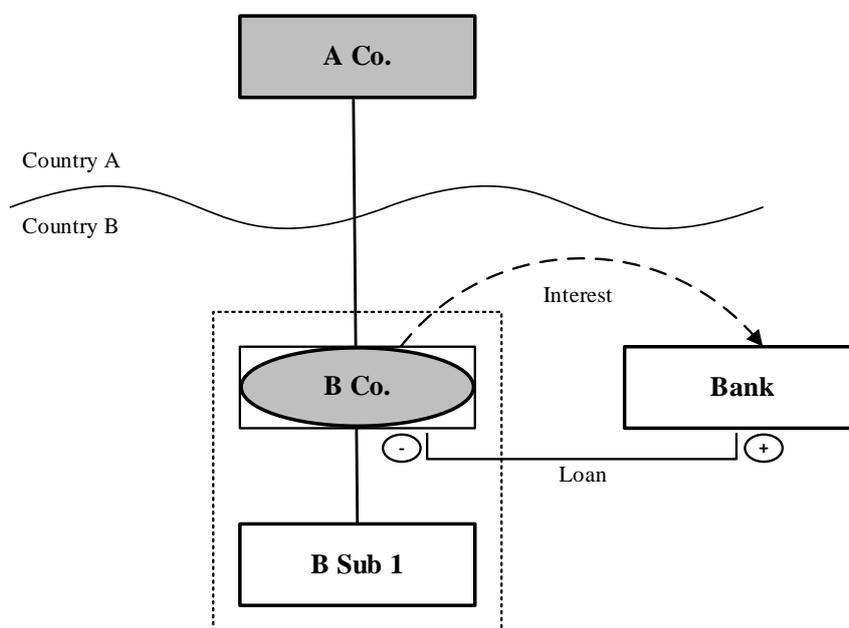
KPMG Comment: Given public statements, it seems unlikely that the US will adopt comprehensive hybrid mismatch rules. Their application in New Zealand will result in the primary rule (denial of interest deductions) applying to financing provided via US “check the box” companies. While this may, prima facie, be revenue positive for NZ, the impact on potential NZ borrowers (including the additional compliance costs) and alternatives needs to be considered.

- 2.22 The creation of a permanent establishment in the payer country can be used to achieve a similar D/NI outcome. For example, a subsidiary company resident in an overseas jurisdiction could borrow from its parent company resident in the same jurisdiction. If the subsidiary allocates the loan to a New Zealand branch, the interest paid on the loan would be treated as deductible in New Zealand (but subject to New Zealand non-resident withholding tax). However, a tax consolidation of the subsidiary with its parent would mean that the interest payment is disregarded in the overseas jurisdiction.

Deductible payments made by a hybrid payer

- 2.23 A simplified arrangement using a hybrid entity to achieve a DD outcome is set out in Figure 2.4.

Figure 2.4: DD arrangement using hybrid entity¹⁹



- 2.24 Under the arrangement, A Co (resident in Country A) owns all the shares of B Co (resident in Country B). B Co borrows from the bank and pays interest on the loan, deriving no other income. As Country A treats B Co as transparent, A Co is treated as the borrower by Country A. However, as Country B treats

¹⁹ OECD 2014 Interim Report at p51.

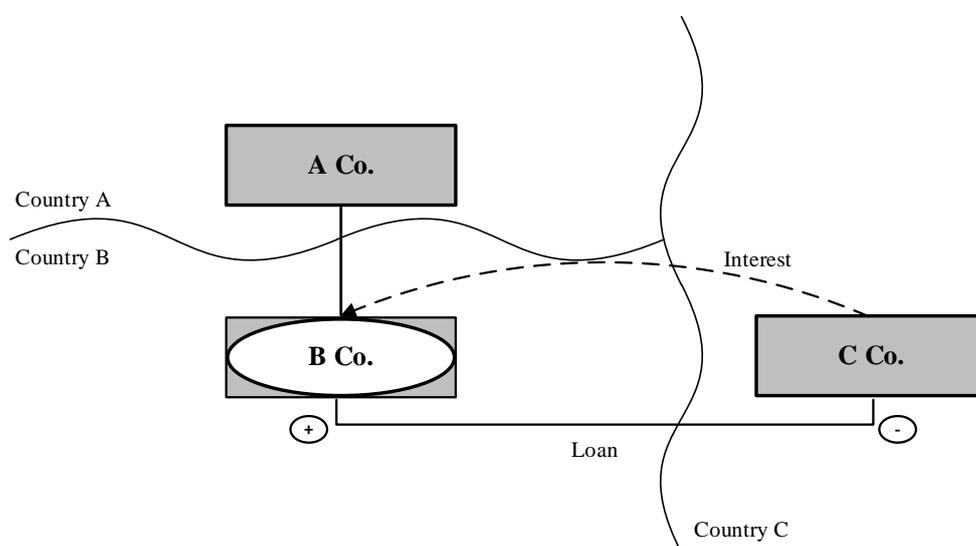
B Co as opaque, B Co is treated as the borrower by Country B. The result is a deduction for the interest expenditure in Country A and B (that is, a DD outcome). If B Co is consolidated for tax purposes with its operating subsidiary B Sub 1, B Co can surrender its tax deduction to B Sub 1, allowing two deductions for the same interest expense to be offset against separate income arising in Country A and Country B.

- 2.25 Australian limited partnerships (treated as transparent in New Zealand, but opaque in Australia) are used to achieve an outbound DD result in essentially the manner described in the example above.²⁰
- 2.26 As with D/Ni, the creation of a permanent establishment in the payer country can be used to achieve a similar DD outcome, if the income and expense of the permanent establishment is eligible to be consolidated or grouped for tax purposes in that country.

Reverse hybrids

- 2.27 A simplified arrangement using a reverse hybrid is set out in Figure 2.5. A reverse hybrid is a hybrid entity that is treated as opaque by its foreign investor, but transparent in the country of its establishment (in the reverse of the examples described above).

Figure 2.5: Payment to a reverse hybrid²¹



- 2.28 A Co (resident in Country A, the investor country) owns all the shares in B Co, (the reverse hybrid established in Country B, the establishment country). Country B treats B Co as transparent, but Country A treats B Co as opaque. C Co (resident in Country C, the payer country) borrows money from B Co and makes interest payments under the loan. The outcome is D/Ni if the interest

²⁰ The Australian limited partnership (ALP) would have an Australian-resident partner and a New Zealand-resident partner, but the New Zealand-resident partner could hold up to 99.99 percent of the ALP in order to maximise the tax advantage (the DD outcome).

²¹ OECD 2014 Interim Report at p45.

paid by C Co is deductible in the payer country (Country C), but not included as income under the domestic rules of either the investor or establishment country (Country A or B), because each country treats the income as having been derived by a resident of the other country, and Country B does not treat the income as sourced in Country B.

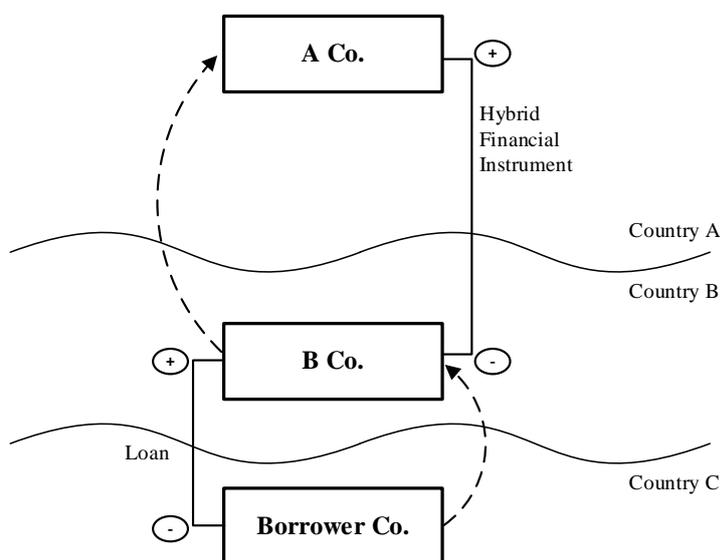
- 2.29 Controlled foreign company (CFC) rules in the investor country that tax the income of residents earned through CFCs on an accrual basis would eliminate such mismatches. However, New Zealand’s CFC rules contain an active income exemption as well as a safe harbour, under which passive income is not subject to accrual taxation if it is less than 5 percent of total income.

***KPMG Comment:** This is another example where New Zealand’s tax policy choices are being impacted by the hybrid proposals. NZ’s previous international tax settings generally required accrual income attribution. This was replaced in favour of a tax regime more in line with that of the rest of the world. The decisions at the time contemplated that CFC income would generally not be taxed. We do not believe a global approach will see other countries amending their CFC settings, given the desire to maintain tax competitiveness.*

Indirect outcomes

- 2.30 The effect of a hybrid mismatch that arises between two countries can be imported into another country to create an indirect D/NI outcome, if the first two countries do not have hybrid mismatch rules. An example of this is set out in Figure 2.6.

Figure 2.6: Imported mismatch from hybrid financial instrument²²



- 2.31 A Co lends money to B Co, a wholly owned subsidiary of A Co, using a hybrid financial instrument, so that payments under the instrument are exempt in Country A, but deductible in Country B. Neither Country A nor Country B has hybrid mismatch rules. Borrower Co then borrows from B Co. Interest

²² OECD 2014 Interim Report at p59.

payable under the loan is deductible in Country C (Borrower Co's country of residence) and taxable income in Country B. The result is an indirect D/NI outcome between Countries A and C (Country B's tax revenue is unaffected as the income and deductions of B Co are offset).

- 2.32 It is difficult for tax investigators to detect imported hybrid mismatches, as detection requires a broad understanding of a taxpayer group's international financing structure. This information is often not publicly available, and can be difficult to obtain from the New Zealand taxpayer. However, if a country were to introduce hybrid mismatch rules without a rule against imported hybrid mismatches that could allow some taxpayers to seek to exploit that gap. This would be against the intended outcome of the rules which is that the tax advantages of hybrid mismatches are neutralised, leading taxpayers to, in most cases, adopt more straightforward cross-border financing instruments and structures.

KPMG Comment: It is unclear how much or even why the risk of detection is mentioned at Paragraph 2.32. If there is no such rule, the risk of detection is irrelevant. If there is such a rule, New Zealand applies a self-assessment regime which places the onus on the taxpayer.

The first two sentences should be discounted in confirming the policy position for New Zealand.

CHAPTER 3

Policy issues

- 3.1 Addressing hybrid mismatches is a key part of the G20/OECD Action Plan (Action Plan) to address base erosion and profit shifting (BEPS). The nature of BEPS means that countries must take a global perspective in tackling BEPS issues, and attempt to reach consensus on a co-ordinated response. In terms of hybrid mismatch arrangements, the double non-taxation result can only arise because of the lack of consistency in the tax treatment of an entity or instrument among countries.
- 3.2 In considering how best to respond to the problem of hybrid mismatch arrangements, the Government is aware that a non-OECD approach could be taken. For instance, some countries are of the view that not implementing the OECD recommendations is in their best interests. Another option is for New Zealand to introduce specific rules targeting the hybrid mismatch arrangements that are known to affect New Zealand.
- 3.3 This chapter discusses the merits for New Zealand of:
- adopting the OECD recommendations
 - introducing a set of targeted anti-hybrid rules and
 - doing nothing in respect of hybrid mismatch arrangements.

Global impact of hybrid mismatch arrangements

- 3.4 The ability of multinational enterprises with access to sophisticated tax advice to take advantage of hybrid mismatch opportunities may provide an unintended competitive advantage over businesses that cannot.²³ The OECD has found some evidence that multinational enterprises with tax planning opportunities tend to have greater market dominance and higher price mark-ups compared with other firms.²⁴
- 3.5 This may lead to welfare losses. For example, the OECD has identified that reduced competition can reduce the need to innovate in order to stay ahead of competitors. Further, differences in the effective tax rate facing multinational enterprises able to exploit mismatches and other firms may also result in a sub-optimal allocation of capital if it means the multinational enterprise crowds out potentially more productive investment by other firms.²⁵

²³ For example, the mismatch may allow the multinational to reduce its prices in the short term with a view to gaining a dominate market share (and then increase prices to increase profits).

²⁴ OECD (2015), *Measuring and Monitoring BEPS, Action 11 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241343-en> (Action 11 Final Report) at p169.

²⁵ Action 11 Final Report at p170. The OECD also notes, however, that if tax planning multinational enterprises are more productive than the firms they crowd out, the overall effect on efficiency is unclear.

- 3.6 A related issue is that global resource allocation may be distorted by the availability of hybrid mismatch opportunities. International investment decisions may be made based on whether a mismatch is available rather than fundamental economics.
- 3.7 From a global perspective, hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by the parties involved as a whole. The use of these arrangements has caused a significant drop in worldwide corporate tax revenue, although precisely estimating this loss is a difficult task. Perhaps the best estimate comes from the OECD, which has put the reduction in worldwide corporate tax revenue due to mismatches and preferential tax regimes at between 1.3 and 3 percent (between US\$33 and US\$79 billion in 2014).²⁶
- 3.8 The drop in tax revenues from the use of hybrid mismatch arrangements has real distributional consequences. It means governments must impose higher taxes elsewhere in their economies in order to deliver the desired level of public services. This reduces worldwide welfare. The costs associated with imposing tax generally increase more than proportionately as tax rates increase. Imposing higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrids is likely to be less efficient than imposing more moderate taxes across all economic actors.
- 3.9 Hybrid mismatch opportunities may also contribute to financial instability through increases in tax-leveraged borrowing, or as a result of businesses entering into investments which are uneconomic before tax, but marginally viable after tax as a result of taking advantage of such an opportunity.
- 3.10 Allowing the use of hybrids is also inequitable as it results in uneven tax burdens across different businesses. This is an issue in itself, but may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations.
- 3.11 The OECD's recommendations represent an agreement by participating countries that hybrid mismatch arrangements should be neutralised and also how they should be neutralised. While tolerating mismatches in some cases may have benefits to one country (at the expense of another), that behaviour carries a range of negative consequences. It harms competition, reduces worldwide revenue collection in an arbitrary and unintended way, results in inefficient investment decisions and damages the public's perception of the "fairness" of the tax system.

²⁶ Action 11 Final Report at p168. The method adopted by the OECD means that losses due to hybrids and preferential regimes cannot be disentangled.

KPMG Comment:

Action 11 Evidence

This section relies on the OECD's Action 11 October 2015 final report. That report is itself hedged on the economic impacts. The second summary of Chapter 1 states:

“This chapter concludes that the significant limitations of existing data sources mean that, at present, attempts to construct indicators of or undertake an economic analysis of the scale and impact of BEPS are severely constrained and as such should be heavily qualified.” (at p17)

In our view, this means that the economic and revenue effects of BEPS stated in these paragraphs should be, at best, weak evidence for the policy position being asserted in the document.

Market dominance

We note it is not clear whether tax planning opportunities create market dominance or can be used because of market dominance. To use UK examples, boycotts of Starbucks have not been matched for calls of boycotts for products and services of other companies. For a New Zealand example of the same point see [link](#).

Strength of conclusions

We note the use of the conditional “may” in paragraphs 3.5, 3.6 and 3.9 of the document.

Hybrid results are or will become preferential regimes

We note the estimate of revenue loss is for hybrids **and** preferential regimes. In our view, the distinction between a hybrid effect and a preferential regime as used by the OECD is arbitrary. In our view, at some point, a hybrid result will become a preferential regime.

A country that does not originally tax an amount (based on whatever policy determinations it considers appropriate) will become aware the regime produces a double non-taxation result. If it does not change that result the regime becomes preferential (because by definition it is an acceptable and deliberate outcome).

We have not analysed the position in detail but it appears that the USA's hybrid results may be an example. The USA appears to continue to support such results because the WTO rules allow such tax policy approaches when they would prevent direct subsidies for exporting. A recent example of USA's concerns, albeit for VATs, can be found [here](#).

As we understand it, this Bill proposes a tariff on goods imported to the USA from countries with a VAT where input tax is allowed. This is

said to be an unfair subsidy. Although it appears to mis-understand the nature of a VAT, it illustrates the desire of the USA to encourage its exporters.

Importance of perceptions of fairness and integrity and their correctness

We **absolutely** acknowledge that perceptions of fairness and integrity of the tax system are important to the analysis of the hybrids recommendations. As this is the most concrete evidence (apart from “other countries are doing it as well”) in support of the proposals it deserves more attention and consideration than it is given.

In our view, the two main drivers of this perception are:

- a sale made to a country should be taxed there; and
- income tax is borne by the company and it should be made to pay it.

In the current environment, an expert view seems to be discounted but we would expect both Government and Officials to be cognisant of the nuances of both positions.

Source of sales income and the right to tax

The international consensus preceding the BEPS project has been that sales made **in** a country can be taxed while sales **to** a country are outside the country’s tax base. That is and has been New Zealand’s position as well. The modern economy has raised fundamental questions of whether that should remain the case. Other BEPS actions seek to re-draw the border and are doing most of the work to re-align the international consensus.

Our view is that the BEPS work broadens the concept of sales **in** a country. It still does not extend to give taxing rights to sales **to** a country.

Who bears the tax?

There is a significant literature on who bears the corporate income tax. Is it labour (i.e. workers and consumers) or capital? New Zealand’s historical position has been that it is labour that bears New Zealand’s income tax on inbound direct investment. Higher taxes means either higher costs for consumers, or lower returns for labour, or both. Lower taxes, other things being equal, benefit both.

The hybrid proposals instead rest on the assumption that the cost of the corporate income tax rests largely on direct capital and its foreign owners. There is, in our, view some justification for that position. Declared and recorded tax expenses can be expected to have an effect on the value of a multinational and therefore on the value of shareholders’ interests in the company.

However, additional taxes may also have an effect on domestic consumers and labour. This is more difficult to see in the modern economy. Consumers do not see such effects as they receive many services “free”. For example, no consumer in New Zealand is charged for a Google search. The search is “paid for” by advertising bought by companies. The cost is included in the charge for the products and services bought by the consumer. Such an indirect effect is not obvious. An increase in the charge may not therefore be material for a consumer.

We see nothing in the document which constitutes a rational analysis of the perception and whether, and to what extent, it should influence policy making. For example, an assessment of the correctness of the views may suggest the alternative is to provide better information on New Zealand’s tax regimes and the underlying tax policy settings (and why they were chosen) to the wider community.

True source of income from equity and existing proxy allocations

Related to both views is the appropriate allocation of taxing rights for income from capital. Traditionally, full taxing rights are allocated to where capital is used. This treats equity capital income as sourced only where such capital is used.

However, where the capital is in the form of debt, both the country of source of the income (where the funds are used) and the country which provides the debt capital are entitled to tax the income. The country of source generally taxes the income at a lower rate by applying a withholding tax.

In our view, these rules, together with thin capitalisation rules for inbound foreign investment provide a proxy for the allocation of income from capital. This acknowledges that a foreign direct investor can employ debt or equity or a mixture of the two.

New Zealand’s domestic law therefore already provides a boundary for taxing income which is considered to be “truly” income sourced in New Zealand.

A hybrid result should not fundamentally change that principled answer. It does not mean that income has not been appropriately allocated to New Zealand. New Zealand has already made that choice.

The case is simply that more tax will be raised at no cost?

Instead, what a hybrid result does is raise the question of whether there is an opportunity to increase the New Zealand tax take without raising the cost to the New Zealand economy. We understand that Officials may have answered this in the affirmative – there is no loss if

the amount would otherwise be taxed. (However, this is at best implied in the document.)

It is not obvious that this result has been well thought through. This is particularly the case as we understand that Australia is seen as the major source of hybrid mis-matches. Australia's franking regime, like New Zealand's imputation regime, creates a preference for domestic rather than foreign taxes. We would therefore expect a marginal loss for Australian investors from imposing greater New Zealand income tax. The decisions are therefore not costless.

The case for implementation is yet to be strongly made

For these reasons, we consider the document does not make the case for the OECD recommendations or at least for their "blanket" implementation in a strongly founded way. This makes it important to consider the specific recommendations carefully.

Uptake in other countries

- 3.12 The Australian Government asked the Australian Board of Taxation to consult on implementation of the OECD recommendations in 2015.²⁷ The Board released a discussion paper regarding implementation, inviting written submissions, on 20 November 2015,²⁸ and reported to the Australian Government in March 2016.²⁹ The Australian Government then committed to implementing the OECD's recommendations on hybrid mismatch arrangements anti-hybrid rules as part of its Budget 2016–17.³⁰ The Board has further been tasked with examining how best to implement the OECD recommendations in respect of hybrid regulatory capital and is due to report back by the end of July 2016.
- 3.13 The Government of the United Kingdom has already consulted on adopting the OECD's approach to addressing hybrid mismatches,³¹ and has now introduced legislation to Parliament (see Schedule 10 of the Finance (No.2) Bill). The intention is that the legislation will have effect from 1 January 2017.³²
- 3.14 The Council of the European Union adopted the Anti-Tax Avoidance Directive in June 2016, which sets out six anti-avoidance measures that all EU member states must implement into their own tax systems by 31 December 2018. One of the six anti-avoidance measures is to implement rules to counteract intra-

²⁷ The terms of reference for this project can be found at

<http://taxboard.gov.au/consultation/implementation-of-anti-hybrid-rules/>

²⁸ Board of Taxation, Implementation of the OECD anti-hybrid rules (2015).

<http://taxboard.gov.au/files/2015/08/BoT-Anti-hybrid-Discussion-Paper.pdf>

²⁹ This report was subsequently released to the public on 3 May 2016.

<http://taxboard.gov.au/files/2016/05/Implementation-of-the-OECD-hybrid-mismatch-rules.pdf>

³⁰ 2016–17 Budget Paper No 2 – Revenue Measures p34.

³¹ HM Treasury and HM Revenue & Customs, *Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements* (December 2014).

³² Refer to s 22 of the Schedule to Clause 33 (Hybrid and Other Mismatches) of the Finance Bill 2016 (United Kingdom).

EU hybrid mismatch arrangements.³³ The European Council, with reference to the OECD recommendations, has also asked the European Commission to propose rules by October 2016 that apply to hybrid mismatch arrangements involving non-EU countries.

- 3.15 Some countries have introduced domestic rules to combat the effects of hybrid mismatch arrangements prior to the OECD BEPS project or without explicitly following the OECD recommendations. These countries include Denmark, France, Spain, Mexico and Austria, while Germany and Hungary have proposed to introduce rules in the future.

KPMG Comment: See our earlier comments.

Australia's proposals may make New Zealand's proposals redundant for the majority of New Zealand's mis-matches. In other words, the ability for New Zealand to increase its tax take without cost may be limited but significant compliance costs and complexity will be introduced. This will not be welfare enhancing for New Zealand.

Given that outcome, New Zealand may be able to take a more targeted and limited approach to its own implementation of the OECD's recommendations.

This could be viewed as "opportunistic". However, we simply mean a better understanding of what the global landscape will look like prior to final decisions will lead to better outcomes for New Zealand. Those areas that need to be dealt with can be, others with no or little benefit can be deferred or not pursued at all.

In any case, other countries can be expected to take a national welfare approach to their tax policy settings; New Zealand should be no different.

At a minimum, consideration should be given to the interaction of Australia's proposals (once the detail of those proposals is clear) with New Zealand's to see whether that should produce a different recommendation for New Zealand.

Impact of hybrid mismatch arrangements on New Zealand

- 3.16 New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the tax effects of a hybrid mismatch arrangement (such as the arrangement in *Alesco*). However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way.³⁴ Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country

³³ Article 9 of Council Directive FISC 104 ECOFIN 628, 17 June 2016.

³⁴ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSSC 115, [2009] 2 NZLR 289 (SC).

involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements. This is also seen in Australia where the “black letter” tax treatment of the hybrid instruments in the *Mills* case referred to above was not reversed by the equivalent Australian anti-avoidance provision, on the basis that the tax benefit was incidental to the commercial benefit.

KPMG Comment: *The acknowledgement that the use of a hybrid arrangement is not necessarily artificial or contrived raises a significant issue. The use of “exploits” in the OECD definition implies an unintended effect. The breadth of the rules and even the examples used suggest that commercial arrangements will be affected by the proposals.*

Countering the hybrid results means that commercial arrangements will be influenced by the tax outcomes. A commercial choice will be limited by a perception that the intended domestic outcomes are inappropriate.

The hybrid proposals should not affect legitimate commercial choices (in a New Zealand context, this includes those allowed under other New Zealand tax regimes, such as the FIF rules).

- 3.17 The New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown. However, the tax revenue at stake is significant in the cases that the Government is aware of, which shows a clear advantage to counteracting hybrid mismatch arrangements. For example, the amount at issue under all funding arrangements comparable to the *Alesco* arrangement referred to in Chapter 2 was approximately \$300 million (across multiple years).

KPMG Comment: *Given the result in Alesco, this amount of revenue is clearly not at stake. We assume that the Government does not mean to imply that Alesco was incorrectly decided.*

We further note, as above, that this is likely to significantly over-state the position. It assumes that equity instruments are the appropriate counter-factual rather than vanilla debt. A simple debt instrument is likely to give equivalent (or potentially higher) tax deductions in New Zealand. The revenue benefit will be offshore.

The same comments may apply to the next quoted revenue loss but this is not clear as the examples and calculations are not disclosed.

Further, in neither case, is there an assessment of the national welfare impact. The unanswered question is whether these amounts were invested in New Zealand?

In relation to hybrid entities, deductions claimed in New Zealand that are attributable to some prominent hybrid entity structures result in approximately \$80 million less tax revenue for New Zealand per year.

- 3.18 However, it is possible that a particular hybrid mismatch will be to New Zealand's benefit (and to another country's detriment). If an arrangement results in the elimination of residence-country taxation, the return to the investor will increase while New Zealand will continue to earn the same level of tax revenue. The investor will have incentives to increase their investment in New Zealand.
- 3.19 On the other hand, a hybrid mismatch may also result in the elimination of tax in New Zealand. If the availability of the hybrid means the investor invests using the hybrid instead of equity – or crowds out investment by another investor who would have invested through equity – the result is a clear welfare loss for New Zealand. Tax revenues would fall and actual investment in New Zealand would remain unchanged.

***KPMG Comment:** The discussion does not make obvious the downstream effects of the “crowding out” of investment. It appears to assume a finite level of investment in New Zealand. The crowded out investment and the alternative investor will make other investments. Those downstream effects do not appear to have been factored into the analysis.*

- 3.20 Importantly, it is generally impossible to tell which of these situations will arise: whether a hybrid mismatch will result in the elimination of residence-country tax or the elimination of New Zealand tax. More broadly, even if it could be shown that New Zealand would be the beneficiary of a hybrid mismatch, it is an open question whether allowing the mismatch to be exploited would be appropriate. The double non-taxation benefits that arise from exploiting hybrid mismatches are (except in very unusual cases) not intended by either country.

***KPMG Comment:** The evidence would suggest that the comment about double non-taxation benefits not being intended is a mis-statement. There are public and obvious examples of hybrid results which have not been countered.*

The Government appears to be substituting the judgement of foreign revenue officials for the judgement of foreign Governments and parliaments for what is and is not intended.

New Zealand would obviously welcome an intentional foreign policy that makes it more attractive for non-residents to invest here.

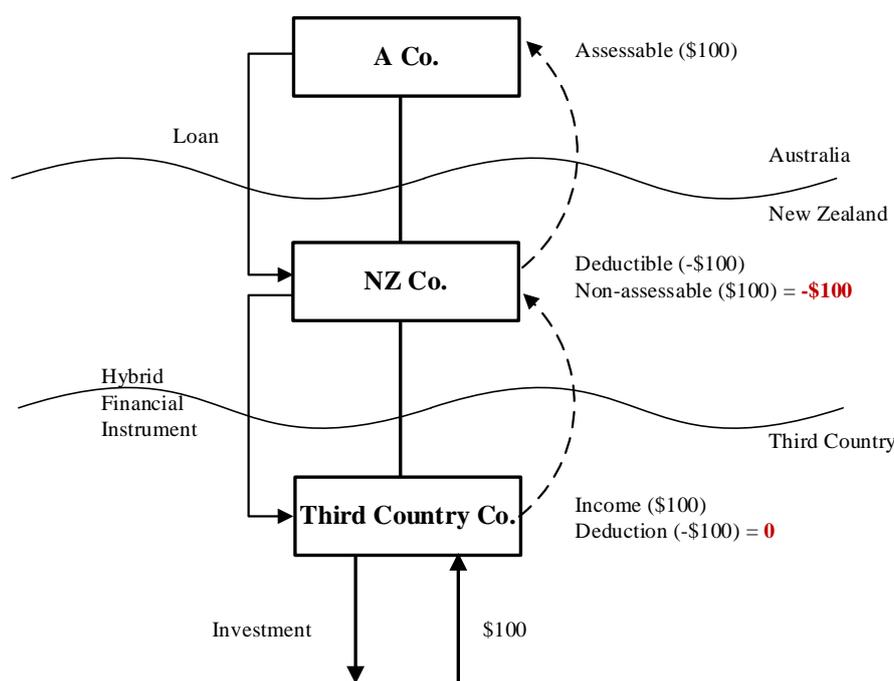
***KPMG Comment:** There are obvious examples of tax policies of foreign countries which do make it attractive to invest in New Zealand. These appear to be ignored by the document. These would include foreign regimes which do not tax foreign income either earned directly (e.g. territorial tax systems) or through certain entities (e.g. by CFCs), which do not tax certain domestic entities (for example, pension funds or charities) even if they invest offshore, or which do not tax equity income if a deduction is available in the source jurisdiction.*

A further obvious example is of a country which does not implement the hybrid recommendations. Any future hybrid results should be considered to be intended.

Allowing the exploitation of unintended mismatches in tax rules to achieve non-taxation of income is another matter.

- 3.21 The use of hybrid mismatches can result in losses to New Zealand in other ways as well. For example, hybrids have been an important feature of tax avoidance arrangements in recent history. A simple example using a hybrid financial instrument is illustrated in Figure 3.1 below.

Figure 3.1: Pure economic loss



- 3.22 Prior to the arrangement, A Co (resident in Australia) invests into a subsidiary, Third Country Co (resident in a third country) by way of a loan. Interest payable under the loan is deductible to Third Country Co under the third country’s domestic rules, and taxable to A Co under Australia’s domestic rules. However, A Co also has a subsidiary resident in New Zealand, NZ Co, paying New Zealand tax. Under the arrangement, A Co instead lends to Third Country Co through NZ Co, using a hybrid financial instrument on the New Zealand/third country leg. As a result, the group can obtain an additional deduction for its financing cost. The outcome is a pure economic loss to New Zealand – a reduction in New Zealand tax with no change in economic activity.
- 3.23 As other countries adopt the OECD recommendations, the case for New Zealand to also adopt the recommendations is strengthened. This is because, depending on how taxpayers react to the rules, a hybrid mismatch arrangement involving a New Zealand counterparty may still be countered (thus eliminating the benefit of the use of the hybrid to New Zealand, if there is one), but the tax collected would be by the counterparty country, rather than New Zealand due to the primary/defensive rule structure of the OECD recommendations. In

particular, there would likely be scenarios where Australia and the United Kingdom (who are both key sources of inbound and outbound investment for New Zealand) would counteract a hybrid mismatch arrangement involving New Zealand and collect all of the resulting revenue. These scenarios provide an incentive for New Zealand to follow Australia and the United Kingdom in adopting the OECD recommendations.

KPMG Comment: Paragraph 3.23 does not make sense. It follows a paragraph which says that New Zealand has an economic loss by allowing a deduction with no corresponding change in economic activity. If New Zealand introduces hybrid rules, it would presumably not allow a deduction so it would also have an increase in tax? Is the counter-factual that New Zealand will no longer be used to fund the third country and the tax will be collected by Country A? In that case, New Zealand still collects the tax because it does not provide a deduction?

3.24 Further, hybrid mismatch arrangements involving New Zealand and other countries that do not adopt the OECD recommendations will be left unresolved unless New Zealand adopts the OECD recommendations.

3.25 However, instead of adopting the OECD recommendations in their entirety, New Zealand also has the option of introducing rules that specifically target the known hybrid mismatch arrangements affecting New Zealand, such as ALPs and MCNs. This approach may reduce complexity, as fewer rules would be needed (at least initially) in comparison to a full adoption of the OECD recommendations. However, it would be difficult to precisely identify the rules that would be needed and the rules that would not.

KPMG Comment: We consider that the difficulty is overstated. In any case, focusing on particular recommendations may allow appropriate early targeting of hybrid results which should be countered. This would allow time for fuller consideration of other issues identified in the document.

Also, it is likely that taxpayers would respond to targeted rules by exploiting other tax planning opportunities left open by this approach. The Government is therefore of the view that adopting the comprehensive set of OECD recommendations at the onset is a proactive, and likely cleaner option. Adopting the recommendations in full also has the advantage of being consistent with the intended approach of Australia and the United Kingdom.

KPMG Comment: It does not however appear to be consistent with the current position of the USA (which we believe is unlikely to change)? What if any effect should this have on New Zealand's tax policy decision making?

3.26 The Government's desire is that any new rules addressing hybrid mismatch arrangements should be effective from a policy perspective, but be as simple as possible to comply with and administer. In considering the need for simplicity, the Government will take into account the fact that in most cases,

the impact of hybrid mismatch rules will be to encourage businesses to use simpler structures which do not require the rules to be applied.

KPMG Comment: The detailed proposals do not appear to take into account this principle of simplicity of compliance. We appreciate that there is an inter-connectedness – i.e. is there a hybrid problem and how simple is the countering measure – of the questions to be answered. In a number of cases, our view that there is no hybrid problem is supported by the complexity of the compliance and the commerciality of the arrangement.

- 3.27 Taking the discussed factors and arguments into account, the best approach for New Zealand is likely to be to co-operate with other countries to eliminate hybrid mismatches by adopting the OECD recommendations. As noted above, when companies exploit hybrid mismatches, the result is that no tax is paid anywhere on a portion of income.

KPMG Comment: See our earlier comments on the use of “exploit” in the document. This is inconsistent with descriptions of some hybrid results having commercial effects.

This leads to an inefficient allocation of investment as cross-border investments where mismatches are available are subsidised relative to other investments. Eliminating this misallocation would increase worldwide efficiency, leading to higher worldwide incomes – which New Zealand will likely share in.

KPMG Comment: The reference to NZ “likely” sharing in any benefit from increased allocative efficiency of investment decisions confirms our view that the benefit to New Zealand is founded on weak evidence and analysis. New Zealand should therefore proceed with caution and care.

CHAPTER 4

OECD recommendations

- 4.1 The OECD's recommended domestic rules under Action 2 aim to eliminate the tax benefit of using a hybrid mismatch arrangement.
- 4.2 The most effective way to do this would be to harmonise the tax rules of the countries concerned. If, for example, all countries had the same rules for distinguishing debt from equity, the opportunity to arbitrage the debt/equity distinction would no longer arise. However, as harmonisation does not seem possible even for the most commonly exploited differences in tax treatment of instruments and entities, this approach is only theoretical.

KPMG Comment: This is consistent with our view that the OECD recommendations are pragmatic, rather than principled.

The document does not answer the question of why harmonisation is not possible. The answers may include:

- Countries are comfortable with the boundaries drawn by their domestic legislation. The hybrid effects are therefore intended;*
- The domestic results produce non-tax results which are deliberately sought by those countries;*
- Not all countries have sufficient policy resource to properly consider and promote good tax policy so that domestic rules reflect good tax policy.*

To the extent that hybrid rules increase income for the other country and not New Zealand, it is only the third answer which justifies New Zealand protecting other countries from themselves.

We acknowledge that care needs to be taken on assumptions of other countries' and revenue authorities' capabilities (or lack thereof). Further, "good tax policy" will be in the eye of the beholder. What is good in the New Zealand context may not necessarily be good in other countries. This is particularly so if tax policy is used as a lever for other public policy objectives. Divergences in view will need to be accommodated.

This suggests that New Zealand should consider the hybrid results for their effect on New Zealand only. The focus should be on whether New Zealand, as opposed to global welfare, is maximised by implementing the hybrid rules. This does not discount the benefit of a global response. That remains a relevant factor but should not be a sole factor.

- 4.3 Instead, the OECD has recommended domestic rules that consist of:
- specific improvements to domestic rules designed to achieve a better alignment between those rules and their intended tax policy outcomes (specific recommendations); and

- rules that neutralise the tax outcomes of a hybrid mismatch by linking the tax outcomes of a payment made by an entity or under an instrument to the tax outcomes in the counterparty country (hybrid mismatch rules).

4.4 There is an expectation that the OECD’s recommended rules be used as a template for reform. By doing so, a consistent approach to addressing hybrid mismatches will be applied across countries. Consistent rules that are consistently applied across countries will best ensure that the rules are effective at eliminating double non-taxation, while minimising the risk of double taxation and compliance and administrative costs for both taxpayers and administrators.

KPMG Comment: In our view, the recommendations do not pay sufficient attention to the potential for resulting double taxation. This may be because the expectation is that alternative arrangements will be entered into. This ignores the commercial effects of the hybrid arrangements.

Further, in our view, the choices made to not limit the application of a rule are stated to be to reduce administration and compliance costs in preference to eliminating double taxation. This may be influenced by countries which have revenue authority assessment rather than self-assessment regimes. New Zealand’s self-assessment regime means that such costs should have a lesser influence than double taxation.

However, the proposed hybrid mismatch rules are designed so that the effects of a hybrid mismatch will be neutralised, even if the counterparty country has not adopted such rules.

4.5 This document proposes that New Zealand introduces domestic rules that are largely in line with the OECD recommendations, with only minor adjustments of those recommendations to ensure that they make sense in terms of New Zealand’s other domestic rules and international tax framework. Final policy decisions will only be made on the outcome of consultation with the businesses that will have to apply any new rules.

Hybrid mismatch rules – OECD recommendations

4.6 The OECD recommendations include a series of “linking rules” which adjust the tax treatment of a hybrid mismatch arrangement in one country by reference to the tax treatment in the counterparty country, without disturbing any of the other tax, commercial or regulatory consequences.

4.7 The target of the rules is D/NI, DD and indirect D/NI mismatches that arise from payments. The OECD considers that rules that, for example, entitle a taxpayer to “deemed” interest deductions for equity capital, are economically more akin to a tax exemption, so do not produce a mismatch in the sense targeted.³⁵ The recommended rules are not generally intended to pick up mismatches that result from differences in the value ascribed to a payment.

³⁵ 2015 Hybrids Report at para 28.

For example, a mismatch in tax outcomes as a result of foreign currency fluctuations on a loan,³⁶ or differences due solely to timing. They do apply to deductions which, although attributable to payments, are not for the payments themselves, such as interest calculated under the financial arrangement rules.

KPMG Comment: the deemed interest deduction example at Paragraph 4.7 not producing a hybrid mismatch is symptomatic of the inconsistency underlying the recommendations. What may be a deliberate design feature of one country's tax system (i.e. a tax exemption) may be (mistakenly or otherwise) considered by another country as giving rise to a hybrid result. The result will inevitably be inconsistent rules, and outcomes, across jurisdictions.

- 4.8 While cross-border mismatches arise in other contexts (for example, the payment of deductible interest to a tax-exempt entity, or the sale of an asset from a capital account holder to a trader), the mismatches targeted are only those that rely on a hybrid element to produce the outcome.³⁷
- 4.9 The OECD recommended rules are organised into a hierarchy, which takes the form of a primary rule and a secondary, defensive, rule. This hierarchy approach means that double taxation is avoided because the defensive rule only applies when there is no hybrid mismatch rule or the rule is not applied in the counterparty country. It also means that the effects of a hybrid mismatch are neutralised by the operation of the defensive rule even if the counterparty country does not have effective hybrid mismatch rules.
- 4.10 If New Zealand follows the approach adopted in the UK legislation, it is likely that these linking rules would form a separate subpart in the Income Tax Act.

KPMG Comment: Our comments on the above paragraphs and those below are generally in the relevant chapters that follow.

We note the importance of a clear set of rules which establish the priority of "ordinary" domestic rules, the new subpart and the application of the General Anti-Avoidance Rule (GAAR).

Recommendation 1: Hybrid financial instrument rule

- 4.11 The hybrid financial instrument rule applies to payments under a financial instrument that can be expected to result in a hybrid mismatch (that is, a D/NI result). A financial instrument can be either a financial arrangement or an equity instrument. The primary rule is for the payer country to neutralise the mismatch by denying the deduction. If it does not, the payee country should tax the payment. Countries only need to apply this rule to payments under financial instruments as characterised under their own domestic law. So, for example, a cross-border lease payment by a resident under an operating lease is not subject to this rule, even if the lessor country treats the lease as a finance lease.

³⁶ 2015 Hybrids Report at para 54.

³⁷ 2015 Hybrids Report at paras 91–98.

- 4.12 The rule also applies to substitute payments, which are payments under a transfer of a financial instrument which in effect undermine the integrity of the rules. This will be the case if the transfer and substitute payment secure a better tax outcome than if the transfer had not taken place.³⁸
- 4.13 The reason for dealing with the deduction first is that it will generally be apparent that a deduction for a payment is being claimed in a country, and then it is possible to determine whether that payment is included in income in the payee country. However, it may not be as straightforward to identify the non-inclusion of a payment in income.
- 4.14 This rule only applies to payments between related parties (broadly, 25 percent or more common ownership) or under structured arrangements. A structured arrangement is defined in Recommendation 10. In broad terms it is an arrangement that is designed to produce a hybrid mismatch. These limitations are designed so that the rules apply in situations when the parties are able to obtain information about, or should be aware of, the tax treatment of the payment to the counterparty.

Recommendation 2: Specific recommendation for the tax treatment of financial instruments

- 4.15 The OECD's recommendations for specific improvements to domestic rules for taxing financial instruments are rules that:³⁹
- deny a dividend exemption (or equivalent relief from economic double taxation) for deductible payments made under financial instruments;
 - prevent hybrid transfers being used to duplicate foreign tax credits for taxes withheld at source, by limiting the amount of a credit to the amount of tax on the net income. A hybrid transfer is a transfer of a financial instrument where differences in two country's tax rules mean each treats the financial instrument as held by a resident.
- 4.16 This recommendation has no limitation of scope (for example, it is not limited to related parties or structured arrangements).

Recommendation 3: Disregarded hybrid payments rule

- 4.17 The third recommendation is to neutralise mismatches arising from payments (whether or not in relation to a financial instrument) by hybrid payers.
- The payer country should deny a deduction for a payment that gives rise to a D/NI outcome.
 - If it does not do so, the amount should be included in income in the payee country.

³⁸ 2015 Hybrids Report at para 79.

³⁹ 2015 Hybrids Report at para 5.

- No mismatch will arise to the extent that the deduction in the payer country is offset against income that is included in taxable income in both the payee and payer country (dual inclusion income).
- Disallowed deductions can be carried forward and offset against dual inclusion income in future years.

So, for example, if a hybrid entity makes a deductible payment to its foreign parent, and that payment is disregarded in the parent country because it treats the hybrid entity as a part of the parent, then *prima facie* the country where the hybrid is resident should deny a deduction for the payment. If it does not, the parent country should tax the payment. Neither response is required if the hybrid entity in the same year derives an equal amount of income which is taxed in both countries (that is, is dual inclusion income).

4.18 This rule applies only to payments between members of the same control group, or parties to a structured arrangement. Entities are in the same control group if they are consolidated for accounting purposes, if they are commonly controlled, if they are 50 percent or more commonly owned, or if they are associated under Article 9 of the OECD Model Treaty.

Recommendation 4: Reverse hybrid rule

4.19 Recommendation 4 applies to any deductible payment made to a reverse hybrid which results in a hybrid mismatch. A hybrid mismatch arises if the payment is not taxable to the reverse hybrid in either its establishment country or the residence country of an owner, but would have been taxable if paid directly to the owner. *Prima facie* an interest payment made to a New Zealand zero-rate PIE in respect of the interest of a foreign investor in the PIE might well be subject to this rule (though it would be out of scope unless there were a structured arrangement). The rule is for the payer to be denied a deduction.

4.20 The rule applies where the payer, the reverse hybrid and its owner are in the same control group, and to a payment under a structured arrangement to which the payer is a party.

Recommendation 5: Specific recommendation for reverse hybrids

4.21 Recommendation 5 contains 3 specific recommendations for domestic rules relating to reverse hybrids. These are to:

- improve controlled foreign company (CFC) and other offshore investment rules to ensure the taxation of the income of hybrid entities in the investor country
- restrict the tax transparency of reverse hybrids that are members of a control group,; and
- encourage countries to adopt appropriate information reporting and filing requirements for transparent entities established in their country (for example, in the case of New Zealand, partnerships, trusts and PIEs).

Recommendation 6: Deductible hybrid payments rule

- 4.22 Recommendation 6 applies to payments by a hybrid payer who makes a payment that is deductible under the laws of both the payer country and the country of the owner, if the payment results in a hybrid mismatch. The owner country should deny the deduction, and if it does not, the payer country should do so. A payment will only give rise to a hybrid mismatch if it is deducted against income which is not dual inclusion income. Disallowed expenditure can be carried forward and offset against dual inclusion income in future periods.
- 4.23 A person will be a hybrid payer if they are entitled to a deduction for a payment in a country where they are not resident, and either they or a related person is also allowed a deduction for that payment in the residence country. They will also be a hybrid payer if they are entitled to a deduction for a payment in their residence country and the payment triggers a second deduction for an investor in the payer in another country.
- 4.24 There is no scope limitation on the primary rule. Disallowance in the payer country (the secondary rule) only applies if the parties are in the same control group or when the person is party to a structured arrangement.
- 4.25 In addition, the Final Report suggests countries may wish to apply this rule to deductions that are not directly attributable to payments, for example, depreciation.⁴⁰

Recommendation 7: Dual-resident payer rule

- 4.26 Recommendation 7 applies to payments by a dual resident payer. If the payment is deductible in both countries, both should deny a deduction to the extent that it is offset against income which is not taxable in both countries.
- 4.27 As with Recommendation 6, Recommendation 7 includes an ability to carry forward any unused deductions and set them off against future dual inclusion income. Losses can also be used in one country if they have become unusable in the other (stranded losses). There is no limitation on the scope of this rule.

Recommendation 8: Imported mismatch rule

- 4.28 To expand the coverage of the rules, Recommendation 8 requires a payer country to deny a deduction for an imported mismatch payment to the extent the rules treat the payment as offset against a hybrid deduction in the payee country. This means that the rules can require disallowance even when the payee is returning the amount received as income, if there is the necessary degree of connection between the payee's receipt of the payment, and the payee making a payment under a hybrid mismatch arrangement.

⁴⁰ OECD 2015 Final Report at para 192.

- 4.29 This rule is proposed to apply only if the payer is in the same control group as the parties to the mismatch arrangement, or when the payer is party to a structured arrangement.

Recommendation 9: Design principles

- 4.30 Recommendation 9 sets out the design principles for the OECD rules, and also their implementation and co-ordination at a domestic level. These are considered in more detail in Chapter 11.

Recommendations 10 – 12: Definitions

- 4.31 Recommendations 10–12 deal with definitions, including in particular, the definition of a structured arrangement, related persons, control groups and acting together.

Double tax agreement commentary

- 4.32 Chapters 13 and 14 of the Final Report intend to ensure that, through modifications to the OECD Model Tax Convention and its Commentary,⁴¹ the benefits of double tax agreements (DTAs) are not inappropriately accessed through the use of hybrid instruments and entities:

- Chapter 13 provides commentary on a proposed change to Article 4(3) of the OECD Model Tax Convention whereby issues of an entity's dual residence can be resolved by the competent authorities of each DTA partner rather than through the application of an interpretative rule as to the place of effective management. The chapter also suggests a domestic law change deeming an entity not to be a resident of a state if that entity is considered to be resident of another state due to the operation of a DTA.
- Chapter 14 provides commentary on the proposed introduction of Article 1(2) to the OECD Model Tax Convention which deals with the treatment of (wholly or partly) fiscally transparent entities.

- 4.33 Where possible, the suggested changes will be incorporated into New Zealand's DTA network through the OECD's work on Action 15 of the BEPS Action Plan (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties), and through bilateral DTA negotiations.

- 4.34 Chapter 15 of the Final Report provides commentary on any potential conflict in the interaction of tax treaties and the OECD's domestic law recommendations. The Government does not foresee any potential conflict between the recommendations and New Zealand's DTA network. However, readers are welcome to submit on that point.

⁴¹ OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing, http://dx.doi.org/10.1787/mtc_cond-2014-en

- 4.35 The DTA commentary will not be considered in Part II of this document as there is no domestic law reform that could be taken in this area (although the dual resident entity domestic law suggestion noted above is discussed in more detail in Chapter 9).

Submissions on Part I

- 4.36 Specific calls for submission are set out in Part II of the document. However, the Government is also open to submissions on any aspects of Part I of the document. Submissions should include a brief summary of major points and recommendations and should refer to the document's labelled submission points where applicable.

KPMG Comment: To reiterate our comments above, in our view, the benefit to New Zealand of adopting comprehensive hybrid rules is founded on weak evidence and analysis. New Zealand should proceed with caution and care. It should focus on direct New Zealand results and domestic outcomes to consider their appropriateness.

PART II

Details of OECD recommendations

KPMG Comment: As a general comment, we note that it would be easier to follow the arguments if the examples used labelled the New Zealand entity. The application of the current New Zealand rules and the proposed hybrid rules would be clearer. As a result, identifying whether there is a problem or not would also be clearer.

CHAPTER 5

Hybrid financial instruments

- 5.1 This chapter discusses and asks for submissions on, various aspects of implementing the first two recommendations in the OECD's Final Report. It first considers changes to existing domestic rules (which relate to Recommendation 2), and then considers issues relating to the linking rules in Recommendation 1.

Recommendation 2

- 5.2 New Zealand already denies a dividend exemption for deductible and fixed-rate dividends (section CW 9(2)(b) and (c)). Indeed, the definition of a deductible foreign equity distribution contains a simple imported mismatch rule. While this rule seems in general satisfactory, there are two situations referred to in the Final Report which New Zealand law does not deal with.

Dividends giving rise to a tax credit in the payer jurisdiction

- 5.3 First, current New Zealand law does not deal with foreign tax systems that use tax credits triggered by dividend payments to effectively refund corporate tax. This is considered in Example 1.11 of the Final Report. Such a regime has the same effect as a dividend deduction,⁴² and it is proposed that section CW 9(2)(c) be expanded to deny exemption for a dividend which gives rise to tax relief equivalent to a deduction in the payer jurisdiction.

KPMG Comment: The substance of the credit mechanism is that it allocates taxing rights away from the country of use of the equity capital. The logical conclusion is that income from equity is appropriately allocated and taxed by the country of use and the investor's country. That is what the FITC regime achieves.

Further, the Example 1.1 analysis is form based. If Country B applied an 11.1% corporate tax rate, which provides the same effective tax rate as a credit for dividends, this rule would not apply. The logical conclusion of the Report's analysis is that all dividends should be taxable with a credit for underlying foreign tax paid. This is not the reality.

Further, this would be a fundamental change which requires detailed consideration. We note specifically the costs of complying with a

⁴² The FITC regime involves a credit triggered by a dividend payment. However, this credit is used to satisfy the shareholder's withholding tax obligation, so is not equivalent to a partial deduction – see para 13 of Example 1.11, OECD 2015 Final Report. *KPMG Comment: Although this analysis is helpful to preserving New Zealand's position with regard to FITC, it illustrates the difficulties of determining whether there is a hybrid mis-match. This analysis takes a form approach. In other circumstances, the document appears to take a substance approach. The conclusion is that a hybrid mis-match is in the "eye of the beholder" (and in NZ's case, the FITC is not).*

dividend credit regime and its interaction with the CFC rules as key factors.

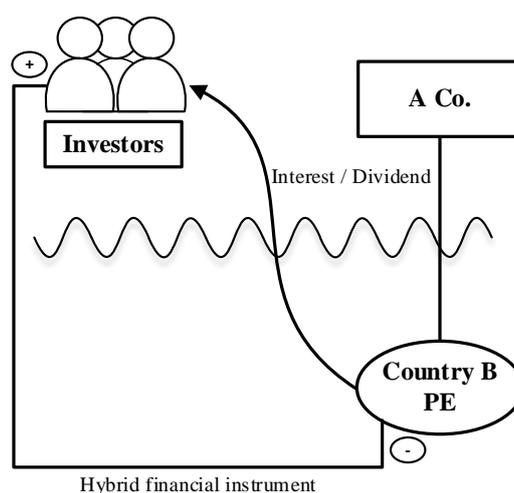
It appears that the mechanics of this proposal will be complex. It will require an apportionment of corporate tax to determine what is in effect deductible or not.

We further note that given activity in Country B and the effect of Country B's rules, it is difficult to see what alternative arrangements could be successfully used. Alternatives could be a branch of ACo, or a look through entity, which provides limited liability but does not attract the corporate tax credit for a distribution. Both of these appear to be at risk of the other recommendations applying – see Chapters 7 and 8 particularly. The rule will therefore affect commercial arrangements.

Denial of imputation credits

- 5.4 Secondly, there is no provision denying the benefit of an imputation credit to a dividend on a hybrid financial instrument. Example 2.1 in the Final Report (reproduced below as Figure 5.1) is an example of a deductible dividend with an imputation credit attached. The dividend is deductible in Country B because the instrument is treated as debt and funds the assets of the Country B branch. In Country A the dividend is taxed as a dividend and imputation credits are required to be attached to it by A Co, representing payments of corporate income tax to Country A. A number of Australian banks have entered into these types of transactions, in some cases using debt raised by their New Zealand branches, that is, New Zealand is Country B.

Figure 5.1: Application of Recommendation 2.1 to imputed dividends⁴³



- 5.5 The Example states that under Recommendation 2.1 Country A should deny the imputation credit, because it is attached to income that has not borne tax in either state. It is true that the attachment of the credit to earnings which have not borne Country A tax may mean that A Co has retained earnings from its domestic activities which it is unable to distribute on a tax paid basis. In that

⁴³ OECD 2015 Final Report, Example 2.1, at p279.

sense the attachment of an imputation credit to a payment is less harmful than the payment being entirely exempt. However, in many cases the distribution of the untaxed earnings can be postponed indefinitely, so there is no practical distinction between exemption and full imputation.

- 5.6 Example 2.1 would not apply to a hybrid instrument issued by the foreign branch of a New Zealand company because New Zealand would tax the branch income. However, there seems no reason not to amend legislation to deny the use of imputation credits to reduce tax on a dividend which is deductible to the payer.

KPMG Comment: A valid reason for not proceeding is that if New Zealand was Country A, it would not allow a deduction for the amount Country B recognises as interest. By definition, if imputation credits are attached, the amount must be a (non-deductible) dividend.

The result would be a deductible amount in Country B, no deduction in New Zealand but the PE's income would be taxed in New Zealand. This is therefore not a hybrid mis-match result. It is countered by definition under existing domestic law.

This appears to be the case even if New Zealand proceeds with an active branch exemption. However, it may need to be considered in more detail should that occur.

The comment that "there is no practical distinction between exemption and full imputation" is only correct if retained earnings are never distributed. That has a commercial cost. Therefore, we do not believe there is direct equivalence.

- 5.7 In relation to Recommendation 2.2, New Zealand has a general rule limiting the ability to claim a credit for foreign tax to the amount of New Zealand tax chargeable on the net income that has been subject to the foreign tax. To ensure that this provision is more closely aligned with Recommendation 2.2, it is proposed that the definition of a "segment" of foreign source income be defined so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign source income.

KPMG Comment: Foreign tax credit rules which require detailed tracing will generate tax planning to ensure that foreign tax credits are not "trapped" or are unusable. Further consideration of a separate rule is required.

For example, as the income is a dividend, it would seem appropriate to treat this as dividend income rather than a separate segment. This is particularly the case as the only other dividends with foreign tax credits are likely to be deductible dividends. Dividends on share transfers are also taxable as deductible amounts. As they would be taxed for the same reason, they could be in the same segment.

Submission point 5A

Submissions are sought on the proposed approaches to implement Recommendation 2 where necessary.

Recommendation 1

General

- 5.8 The hybrid financial instrument rule in the OECD's Recommendation 1 applies to payments under a financial instrument that can be expected to result in a hybrid mismatch (that is, a D/NI result). A financial instrument can be either a debt or an equity instrument. For this purpose, an equity instrument would include any form of ownership interest in an entity which is not treated as fiscally transparent.
- 5.9 A simple example of a hybrid financial instrument is given in Figure 2.1 in Chapter 2.
- 5.10 A D/NI result arises when a payment is deductible to the payer, to the extent that that payment is to a person in a country where the payment would not be fully taxed within a reasonable period of time as ordinary income to a taxpayer of ordinary status, and a reason for that non-taxation is the terms of the instrument. Imposition of withholding tax on the payment by the payer country is not full taxation as ordinary income. D/NI outcomes can arise due to inconsistent characterisation of the financial instrument, or when the payer is entitled to a deduction before the payee has to include an amount in income (typically because the payer is on an accrual basis but the payee is on a cash basis).
- 5.11 The primary rule is for the payer country to neutralise the mismatch by denying the deduction. The payer country is any country where the payer is a taxpayer. It does not require the payer to be resident, and a payer can have more than one payer country. If the payer country does not deny the deduction, under the secondary rule the payee country should include the payment in the payee's income. The payee country is any country where the payee is a taxpayer.

Rule only applies to financial instruments under domestic law

- 5.12 Subject to two exceptions (considered below), countries only need to apply this rule to payments under financial instruments as characterised under their own domestic law. So, for example, a cross-border lease payment by a New Zealand-resident under a lease that is not a financial arrangement would not be subject to disallowance under this rule, even if the lessor country treats the lease payment as partially a return of principal under a finance lease.⁴⁴ The definition of a financial instrument is considered in Chapter 12.

⁴⁴ OECD 2015 Final Report, Example 1.25.

Rule only applies to payments

- 5.13 This rule only applies to payments between related parties (broadly, 25 percent or more common ownership) or structured arrangements. These definitions are discussed in Chapter 12.
- 5.14 The rule does not apply to deductions which are not for payments. Thus it does not apply to deemed deductions on an interest-free loan, but it does apply to deductions which arise from bifurcating an interest-free loan between debt and equity (Final Report, Examples 1.14 and 1.16). So, the deductions claimed by the taxpayer in *Alesco* would be disallowed by the primary rule in New Zealand, and if New Zealand did not have hybrid rules, be taxable in Australia under the defensive rule. They would not be affected by Recommendation 2, because Australia did not recognise the optional convertible note as giving rise to a dividend. The rule also does not apply to a bad debt deduction, which is attributable to a non-payment, rather than a payment – see Final Report, Example 1.20.

KPMG Comment:

The full effect of the recommendation is unclear.

The effect of the defensive rule

The paragraph implies, but does not confirm, that if New Zealand has the primary rule that its application is determined by ignoring the fact of Australia having the defensive rule. (This is the most likely scenario, given other references to Australia in the document.) We understand that this would mean that New Zealand would deny the deduction.

If so, this is an example of New Zealand applying the hybrid rules because there is no cost to doing so (it would be taxed in Australia if the deduction was not denied). This is not necessarily a “tax at a no cost” result. Tax paid in New Zealand has a different result from tax paid in Australia.

We would expect the application of the primary rule would therefore more likely than not result in different funding arrangements. As this is more likely to be debt funding, New Zealand will not increase its revenue.

Does section BG 1 still apply?

*Section BG 1 was found by the Courts to apply to the *Alesco* facts. To the extent that continues to apply, there is no additional New Zealand tax raised by the hybrid mis-match rule.*

*In *Alesco* the taxpayer was allowed a deduction under New Zealand’s black letter law. It was denied a deduction because the GAAR applied.*

The proposal is that New Zealand denies a deduction if the amount is not taxable. This will be part of New Zealand’s black letter law.

It is not clear whether, if Australia taxes this amount (by operation of a substantive rule or because of the defensive rule if our understanding on the primacy of the hybrid rules is incorrect), that means that the outcome (D/T) will be contemplated as the hybrid rules do not apply. The GAAR may not apply. The seemingly perverse outcome of implementing the hybrid rules may be that New Zealand allows a deduction. This is caused by Australia taxing the amount. (This is not intended to be a full analysis of BG 1 should the hybrids proposals proceed. It illustrates the types of issues which it will raise and which are not covered in the document.)

This confirms our general point that New Zealand's domestic rules have been developed for good reason. New Zealand's rules should be focused on achieving the outcomes that New Zealand desires independent of other countries' rules.

Further, see our comments at chapter 11 on the need to clearly establish the relationship between the hybrid rules and the GAAR.

Recommendation 2

We understand the reference to recommendation 2 is simply to confirm that Australia's implementation of recommendation 2 would not apply to tax the amount (as there is no payment).

Practical considerations

- 5.15 This rule would mean that any person claiming a deduction for New Zealand tax purposes under a cross-border financial arrangement needs to consider, before claiming the deduction, whether:
- the deduction arises as a result of a payment that (assuming no change in the parties to the arrangement) is or will be made to a related person (applying a 25% threshold, as discussed below) or pursuant to a structured arrangement; and (if the answer to the first question is yes)
 - whether under the laws of the country of the payee, the payment would be taxed as ordinary income in the hands of a taxpayer of ordinary status within a reasonable period of time. If it would not, then no deduction can be claimed.
- 5.16 Also, any person entitled to receive a payment under a cross-border financial instrument will need to consider, if that payment is not fully taxable (including where it is taxable but carries a credit, other than for foreign withholding tax), whether:
- the payment is from a related person or pursuant to a structured arrangement; and (if the answer to the first question is yes)
 - whether under the laws of the country of the payer, the payment is deductible to a taxpayer of ordinary status. If it is, then the payment is taxable in the year of the deduction.

Particular tax status of counterparty not relevant

- 5.17 Only hybrid mismatches that arise as a result of the terms of an instrument are relevant. For example, if a New Zealand borrower pays interest to a related party who is tax-exempt, there will be no hybrid mismatch if the related party would have been taxable on the interest were it not tax-exempt. However, there will be a hybrid mismatch if the related party would not have been taxable on the interest if it were not tax-exempt (Final Report, Example 1.5).
- 5.18 Another issue is the relevance of deduction or inclusion that arises only because a payer or payee holds an instrument on revenue account. Generally the principles expressed above mean that such deductions or inclusions are ignored for purposes of this rule. For example, suppose a purchaser on revenue account is entitled to a deduction for the cost of acquiring a financial instrument whereas the vendor is on capital account does not include the sale price in its income. That mismatch does not mean that the hybrid financial instrument rule applies to the payment (see Final Report, Example 1.28).

Differences in valuation of payments not relevant

- 5.19 A borrower in a foreign currency loan will generally have a foreign currency gain or loss with respect to the loan. Assuming the loan is in the currency of the lender's residence, the lender will have no corresponding gain or loss. If the borrower has a loss, the loss is not thereby denied under the hybrid mismatch rules (Final Report, Example 1.17). The situation would be the same if the loan were in a third currency, even if currency movements mean there is a foreign exchange loss to one party and a foreign exchange gain to the other.
- 5.20 However, differences in valuation that lead to different characterisations of a payment may lead to Recommendation 1 applying – see Final Report Example 1.16, relating to an optional convertible note.

Timing differences

- 5.21 Where the payer and payee under a financial instrument are in different jurisdictions, it is not uncommon for them to recognise income/expenditure from the instrument on different bases. For example, a payer may be entitled to a deduction for a payment on an accrual basis, whereas a payee is taxable on a cash basis. In that case, there is a hybrid mismatch, which is *prima facie* subject to Recommendation 1.
- 5.22 The Final Report suggests⁴⁵ that a deduction should not be denied if the payment giving rise to the deduction is included in income in an accounting period that begins within 12 months of the end of the period in which the deduction is claimed. If this test is not met, the payer should still be entitled to a deduction if it can satisfy the tax authority that there is a reasonable expectation that the payment will be made within a reasonable period of time, and once made will be included in ordinary income. A reasonable period is

⁴⁵ From p34.

one that might be expected to be agreed between arm's length parties. Final Report Example 1.21 applies these principles.

- 5.23 The Final Report does not provide for any denied deductions to be carried forward and allowed if and when the payee does recognise income.
- 5.24 The UK appears to have adopted this approach, along with a provision that if a supposition ceases to be reasonable, consequential adjustments can be made.
- 5.25 The Australian Board of Taxation Report recommends a different approach. It suggests that a gap of up to three years between deduction and inclusion should not attract operation of the rule, whereas a longer gap should mandatorily do so. It also suggests that any deduction denial should reverse when and if the payee recognises the corresponding income. This is essentially a carry-forward loss proposal. The proposal seems to mirror what would happen in the case of inclusion under the defensive rule. If the amount of a deduction in a payer jurisdiction were included in the payee's income under the defensive rule, and the payment giving rise to the income inclusion was later received, it would not be appropriate to tax the payment again, and rules against double taxation would generally achieve this. This supports the Board of Taxation carry-forward proposal in relation to the primary rule.

Taxation under other countries' CFC rules

- 5.26 When a payment gives rise to a D/NI outcome, tax may still be imposed on the payment under a CFC regime. In this case the tax would be imposed on the owners of the payee, by the owner country. This is discussed at paragraph 36 and following of the Final Report. The Report gives countries the choice as to whether to treat CFC inclusion as taxation of the payee. This would be relevant for a New Zealand taxpayer in:
- determining whether to apply the primary response – in this case the New Zealand payer would need to establish that the payment made by it was subject to tax in the hands of the payee's owners under a CFC regime; or
 - determining whether or not to apply the secondary response – in this case the New Zealand payee would need to establish that the payment made to it was subject to tax in the hands of the payee's own owners under a CFC regime.
- 5.27 The Report also says that a taxpayer seeking to rely on CFC inclusion should only be able to do so if it can satisfy the tax authority that the payment has been fully included under the laws of the CFC country. Unlike the general approach in Recommendation 1, this will require proof of actual taxation of the amount.

Application of rule to transfers of assets

- 5.28 Recommendation 1 generally does not apply to amounts paid for the transfer of an asset. However, transfers can give rise to hybrid mismatches in three different situations.

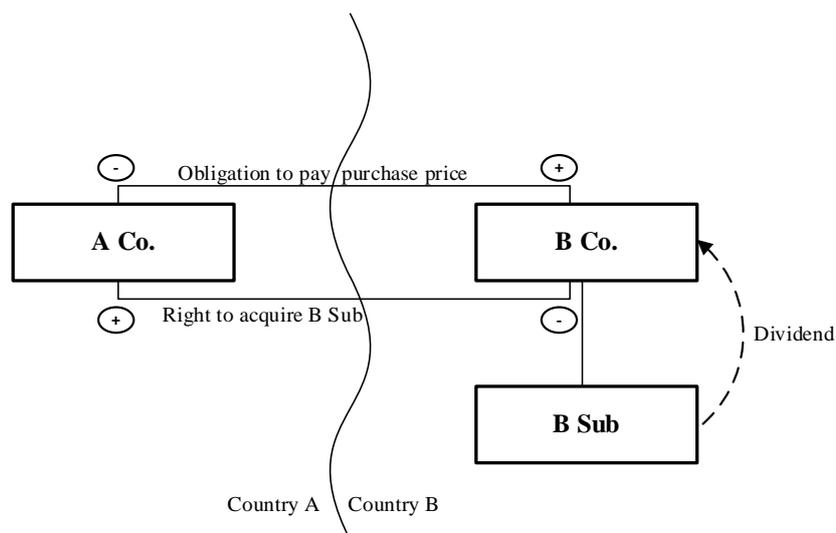
Portion of purchase price treated as payment under a financial instrument

- 5.29 First, there may be a hybrid mismatch in a cross-border asset sale if one or other country treats a portion of the purchase price of any asset as attributable to a financial instrument (see Example 1.27 of the Final Report). For example, if a purchaser is *prima facie* entitled to a deduction for a portion of a deferred purchase price under the financial arrangement rules, but the non-resident related party vendor treats the entire amount as purchase price, the hybrid financial instrument rule will deny the purchaser a deduction. Because the application of the rules depends on the tax treatment of a payment for a taxpayer of ordinary status, the linking rule will apply to deny a deduction even if the non-resident vendor is a trader and treats the purchase price as income for purposes of its home country taxation (Example 1.29 of the Final Report).
- 5.30 The Final Report also states that when a person is entitled to a deduction for a payment only because the person holds an asset on revenue account, and the person is fully taxable on their economic gain or loss from the asset, that deduction should not be denied by the linking rule (see Final Report paragraph 52 and Example 1.28). So if the purchaser in the previous paragraph is entitled to a deduction for a payment because it is a trader, that deduction should not be denied.

Hybrid transfers

- 5.31 A second way the hybrid financial instrument rule can apply to a transfer of an asset is if it is a hybrid transfer. A hybrid transfer is a transaction, such as a share loan or a share repo, where the transferor and transferee are both treated as the owner of a financial instrument. This is usually because the terms of the transfer require both that the asset, or an identical asset, is returned to the transferor, and also that the transferor is compensated by the transferee for any income from the asset that arises during the term of the arrangement (whether or not received by the transferee). This means that economic risk on the asset remains with the transferor throughout the period from the initial transfer through to the retransfer. An example of a hybrid transfer is given in Figure 2.2 in Chapter 2 of this document, which is repeated here for convenience. Further examples are the transactions that were the subject of *BNZ Investments Ltd v CIR* (2009) 24 NZTC 23,582 and *Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834.

Figure 5.2: Hybrid transfer – share repo (repeated Figure 2.2)



5.32 New Zealand is generally a form country, so in Figure 2.2, if B Co (the share borrower) is a New Zealand company it will be treated as owning the B Sub shares, and deriving a dividend from B Sub, rather than as having lent money to, and deriving a financing return from, A Co. However, because Country A is a substance country, A Co is treated as owning the B Sub shares, receiving the dividend, and making a deductible financing payment to B Co, equal to the amount of the dividend. Accordingly, if Country A does not have hybrid rules, and A Co and B Co are either related parties or the repo is a structured arrangement, then the effect of the hybrid transfer rule is that B Co will have to recognise additional income, unless it is taxable on the dividend from B Sub with no imputation credits.

5.33 In the case of a share loan which is a hybrid transfer, the hybrid mismatch will generally arise because:

- the manufactured dividend payment made by the share receiver to the share supplier in the substance country is treated in the same way as a dividend in the share supplier country, which will often be exempt;
- the same payment will often be deductible to the share receiver in its country.

Substitute payments

5.34 The third situation in which the hybrid financial instrument rule can apply to a transfer of a financial instrument is if the transfer involves a “substitute payment” (as defined). A substitute payment is a payment under a transfer of a financial instrument which represents a financing or equity return on the underlying instrument and which undermines the integrity of the hybrid rules. This will be the case if the underlying payment (that is, the one that gives rise to the substitute payment):⁴⁶

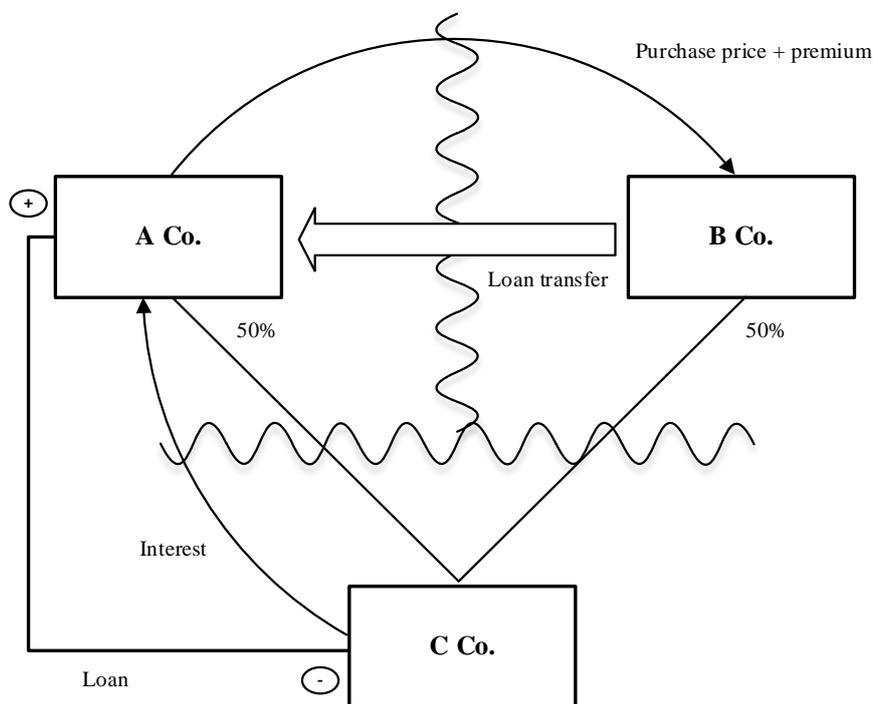
⁴⁶ OECD 2015 Final Report at para 79.

- is not included in the income of the substitute payer;
- would have been included in the income of the substitute payee; and
- gives rise to a hybrid mismatch.

5.35 In any of these circumstances, if the substitute payment gives rise to a hybrid mismatch, the hybrid rules will deny a deduction to the payer (primary response) or tax the payee (secondary response).

5.36 Example 1.36 of the Final Report shows a substitute payment, and is reproduced below.

Figure 5.3: Deduction for premium paid to acquire a bond with accrued interest⁴⁷



5.37 The substitute payment is the premium portion of the amount paid by A Co to B Co for the transfer of the bond with accrued interest. The transfer is neither a financial instrument, nor a hybrid transfer. However, the premium is a payment in substitution for the payment of the accrued interest. It is deductible to A Co and treated as a capital gain to B Co, so it gives rise to a hybrid mismatch. On the facts of the example, the payment by A Co to B Co is a substitute payment because the payment of the coupon to the vendor would itself have given rise to a hybrid mismatch. The result would be the same if the coupon payment were taxable to the vendor. Accordingly, if the purchaser and vendor are related, or the sale is a structured arrangement, the payment of the premium will be subject to the hybrid mismatch rule.

⁴⁷ OECD 2015 Final Report, Example 1.36, at p274.

Regulatory capital

5.38 The Final Report gives countries the option to exclude regulatory capital from their hybrid rules. A typical example is when the parent company in a multinational banking group issues regulatory capital instruments to the market for the purpose of using the funds to provide regulatory capital to a bank subsidiary in another country. Countries are free to exclude the intra-group regulatory capital from the hybrid rules. The Final Report also states that an exclusion of bank regulatory capital from one country's rules does not require any other country with hybrid rules to refrain from applying them to regulatory capital instruments between the two countries.

Other exclusions

5.39 Recommendation 1.5 provides an exception to the primary response for investment vehicles that are subject to special regulatory and tax treatment that:

- is designed to ensure that while the vehicle itself has no tax liability, its investors have a liability, arising at more or less the same time as the gross investment income was derived by the investment vehicle; and
- ensures that all or substantially all of the vehicle's investment income is paid and distributed to the owners within a reasonable period after the income is earned; and
- taxes the owners on the payment as ordinary income.

5.40 An example is a regulated real estate investment trust, which is entitled to a dividend paid deduction but required to pay out all of its earnings on a current year basis.

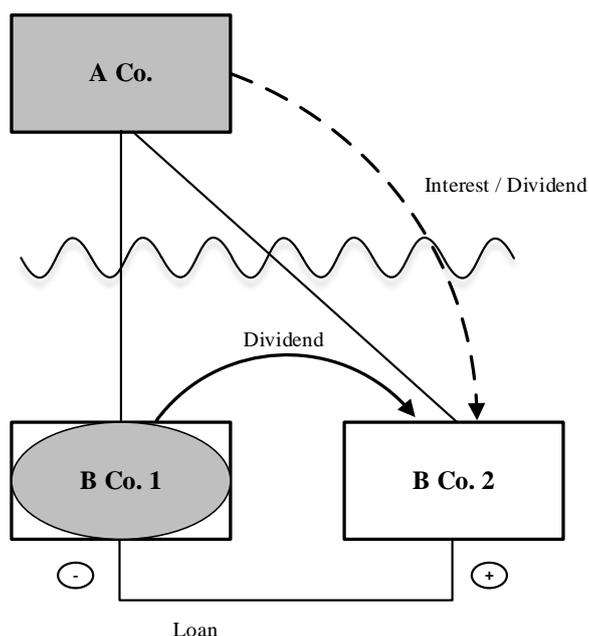
Application to New Zealand

5.41 A number of issues are worthy of further discussion and submission as to how Recommendation 1 could be incorporated into New Zealand law.

Applying the secondary rule to hybrid dividends

5.42 In New Zealand's case, the secondary rule (taxation of amounts that are deductible in the payer jurisdiction) will also require the denial of imputation credits attached to a dividend which is deductible in another jurisdiction. This could arise in the situation set out in Example 1.23 of the Final Report, reproduced below, where New Zealand is Country B.

Figure 5.4: Payment by a hybrid entity under a hybrid financial instrument⁴⁸



5.43 Accordingly, the Government proposes to amend the law so that imputation credits attached to a dividend on a hybrid financial instrument are not included in a New Zealand shareholder's income and do not give rise to a tax credit. This non-inclusion would not affect the paying company. This ensures that application of the rule does not allow two lots of imputation credits to exist for what is in reality the same income. Denial of one amount of imputation credits correlates with the fact that the dividend payment has given rise to a foreign tax benefit.

5.44 As this example makes clear, implementing the defensive rule in Recommendation 1 will also require New Zealand to tax intra-group dividends that give rise to a hybrid mismatch under the hybrid financial instrument rule, even if these are between members of a 100 percent commonly owned group (whether or not consolidated).

KPMG Comment: In both cases, the proposals protect the foreign country's, and not New Zealand's, tax base. The dividend is correctly treated as capable of having imputation credits attached and as being exempt under New Zealand's domestic rules.

In the first scenario, it is not clear whether B Co 2 would still have imputation credits received recorded in its ICA. These may be important to ensure that there is no double taxation when profits are ultimately distributed. However, further ICs may not be required as tax paid by B Co 2 on the dividend would generate imputation credits.

⁴⁸ OECD 2015 Final Report, Example 1.23, at p235.

Submission point 5B

Submissions are sought on whether there are any issues with the proposed approach in applying the secondary rule to hybrid dividends.

Timing mismatches

5.45 With respect to timing mismatches, the Australian Board of Taxation approach (see earlier paragraph 5.25) may have advantages for New Zealand. Denial of deductions (with carry forward) where there is a deferral of recognition of the corresponding income for more than three years:

- applies or not based on objective criteria which can be applied on a self-assessment basis, that is, without the need for the Commissioner to exercise any discretion; and
- seems both economically appropriate and consistent with the application of the secondary rule.

KPMG Comment: The application of this rule in New Zealand is unprincipled as:

- *withholding tax will be paid on the basis that a deduction is available so there is double taxation (unless the hybrid rules apply before the deemed payment for withholding tax applies, but we note the contrary is proposed, see chapter 11);*
- *the treatment of the amount as incurred and deductible is based on principled approaches to the allowance of deductions;*
- *any period is arbitrary if it does not have regard to the commercial terms of the arrangement. For example, commercial loan terms are often structured to match expected cashflows from a project. Such loans should not be subject to the rules.*

Submission points 5C

Submissions are sought on:

- whether the approach recommended by the Australian Board of Taxation would be an acceptable one for New Zealand;
- what alternatives might be better to deal with timing mismatches; and
- what thresholds should apply to determine when the rule would apply to a difference caused by different income and expenditure recognition rules.

Effect of CFC inclusion on application of Recommendation 1

5.46 The need to treat CFC taxation of a payee's owner to be treated as taxation of the payee itself is not pressing in the case of the secondary response. Taxation

of the payee in the payee country under the defensive rule is likely to simply reduce CFC taxation in the owner country.

- 5.47 Given the complexity of establishing the extent to which taxation under a CFC regime should be treated as inclusion for purposes of the hybrid rules, the fact that there is no need to do so when applying the secondary response, and the fact that there are usually alternatives to the use of hybrid instruments, it is not proposed to treat CFC taxation as relevant in applying Recommendation 1.

KPMG Comment: We consider these proposals are unprincipled. The application of CFC rules in the owner's country will potentially overturn the D/NI conclusion, which justifies the application of the hybrid rules in the first place. If double non-taxation is the true target of the rules, then the rules should only apply if there is in fact double non-taxation.

We appreciate the complexity that this might bring but note:

- *With self-assessment, the onus is on the taxpayer to show that the foreign CFC rules apply to tax the amount;*
- *A hybrid may correctly prevent double taxation if CFC rules apply;*
- *Alternatives may be less commercially applicable.*

Submission point 5D

Submissions are sought on whether this approach as to CFC inclusion will give rise to any practical difficulties.

Taxation of FIF interests

- 5.48 If a New Zealand resident holds shares subject to the FIF regime, and accounts for those shares using the fair dividend rate (*FDR*), cost or deemed rate of return (*DRR*) method, the dividends on those shares are not taxable. Instead the resident returns an amount of deemed income. Dividends are only taxable if the holder uses the comparative value (*CV*) or attributable foreign interest (*AFI*) method (note that when those two methods are being used, if the dividend is deductible in the foreign country it will not be exempt in New Zealand even if the shareholder is a company).
- 5.49 FIF taxation therefore presents at least two problems for applying Recommendation 1.
- The non-resident payer of a deductible dividend to a New Zealand payee, if resident in a country with the hybrid rules, will not know how a New Zealand taxpayer of ordinary status would treat the dividend, and therefore will not know whether, or to what extent, it is denied a deduction for the dividend by the primary response in its own country.
 - When the New Zealand payee is applying the defensive rule (in a case where the non-resident payer of a deductible dividend has not been denied a deduction), if the payee is not applying the CV or AFI method,

the payee will need to determine how much of the dividend has not been taxed, in order to know how much additional income to include.

5.50 Possible solutions are to:

- deny the FDR, cost and DRR methods to shares on which any dividend would be deductible to the payer. This would be similar to the existing requirement to use the CV method for a non-ordinary (generally, debt-like) share (section EX 46(8));
- include a deductible dividend in the holder's income, in addition to income already recognised under the FDR, cost or DRR method. This would be similar to the exclusion of deductible dividends from the general exemption for foreign dividends received by New Zealand companies in section CW 9 (though this exclusion does not apply to interests accounted for under the FDR, DRR or cost method);
- include a deductible dividend in the holder's income only to the extent that it exceeds the income otherwise recognised on the shares. This is somewhat similar to the concept of a top-up amount (defined in section EX 60) that applies when a person uses the DRR method.

5.51 As long as one of these solutions is adopted, there should be no need for a non-resident payer of a deductible dividend to a New Zealand payee to apply the primary response.

KPMG Comment:

Principle

It is not clear why the FIF rules present any hybrid concerns. The FIF rules have been deliberately designed to tax a deemed rate of return as proxy for dividend income (through the FDR regime). This was set at a rate that was expected to exceed the actual dividend yield from overseas investments. The aim was to broadly tax a dividend yield approximating what an Australasian listed stock would pay.

The fact that the FIF rules are a "code" was a deliberate design choice. The FDR method was aimed at broadly aligning with the tax position of a NZ investor in NZ shares. The application of hybrid rules, would result in New Zealand taxing FIF investments more heavily than domestic investments

In our view, Officials should clearly articulate the policy of the FIF rules to support the view that the technical exemption of a dividend from a FIF does not produce a D/NI result. No specific hybrid rule is required.

Breadth of application

We have corresponded with Officials regarding our concerns of the breadth of the definition of structured arrangement (see chapter 12) and its interaction with this analysis. There is a real potential for the hybrid rules to inappropriately override the FIF rules in unrelated scenarios.

This will potentially impact compliance for PIEs and others, including “mum and dad” investors, which rely on the certainty of the FDR method. The latter are likely to be able to apply the hybrid rules in a cost effective way.

Officials should ensure that the rules as they are drafted and are applied (if it proceeds) does not inappropriately override the FDR method.

Submission point 5E

Submissions are sought on which of these FIF approaches would be preferable and why, and whether there is another better approach.

Transfers of assets: revenue account holders

- 5.52 Recommendation 1 could apply to an asset transfer involving a New Zealand party. For example, suppose a New Zealand resident purchases an asset from a related party on deferred payment terms, and is entitled to deduct a portion of the price as financial arrangement expenditure. If the vendor treats the entire amount as being from the sale of the asset, then there will be a hybrid mismatch, and the purchaser will be denied a deduction for the expenditure.
- 5.53 The treatment if the New Zealand resident is acquiring the asset on revenue account (for example, because it is a trader), is less clear. As set out above, the Final Report states that where a person is entitled to a deduction for a payment only because the person holds an asset on revenue account, and the person is fully taxable on their economic gain or loss from the asset, that deduction should not be denied by the linking rule.
- 5.54 However, revenue account holders are not entitled to include in the cost of trading stock the element of their purchase price which is treated as financial arrangement expenditure (section EW 2(2)(d)). The denial of a deduction for that expenditure under the linking rule would not include it in the cost of trading stock. Also, non-taxation of income (for example, dividends on shares accounted for under the FDR method) is not turned off for revenue account holders. So, it is not the case that revenue account holders are always subject to income tax on all of their economic income.
- 5.55 Given that New Zealand does not tax revenue account holders on the basis referred to in paragraph 52 of the Final Report (referred to above), it is not proposed to exempt revenue account payers from the effect of the hybrid rule.

KPMG Comment: *We refer to our comments on the FIF analysis above for the comments in 5.54.*

The non-inclusion of financial arrangement expenditure as part of the cost of the trading stock/revenue account property does not justify the application of the rule. The reason that amount is not included in the

cost is to ensure the expenditure is not double counted. It gives priority to the financial arrangement rules for the timing of the deduction. The result of the New Zealand rules is that the full economic gain is taxed albeit at different times.

Put another way, the document's analysis appears to be:

- New Zealand, on a principled basis, deems an amount to be interest and not the cost of property;
- This justifies treating the deemed interest amount as non-deductible.

This analysis is unprincipled and illogical, in our view. Clearly, revenue account holders should be exempt from the rules.

Submission point 5F

Submissions are sought as to whether revenue account holders should have an exemption from the rules.

Transfers of assets: hybrid transfers

- 5.56 New Zealand does have some specific tax rules for share loans and repos (the rules applying to returning share transfers and share lending arrangements, both as defined in the Income Tax Act 2007). Generally, these do not treat the share supplier as continuing to own the shares (though there is an exception for returning share transfers when the share supplier uses the FDR method to determine its income from foreign shares).⁴⁹ The closest they come is that in relation to a share lending arrangement the share supplier is treated as owning a *share lending right* for the period of the arrangement.
- 5.57 As referred to above, New Zealand has unique rules relating to the taxation of dividends on foreign shares. While dividends from ASX listed shares are generally taxable, other dividends on foreign shares may or may not be taxable.
- 5.58 Again, the New Zealand tax regime creates a difficulty for both counterparty countries (in this case, the country where the repo or share loan counterparty is resident, rather than where the share issuer is resident) and for New Zealand. Again, it would be possible to solve these issues by having a rule which would ensure that dividends paid on foreign shares to a New Zealand person who is party to a hybrid transfer with respect to the shares are always taxable, applying one of the approaches referred to in paragraph **Error! Reference source not found.** The taxation of dividends paid on New Zealand shares held by a New Zealand share receiver who is a party to a hybrid transfer would be unchanged, unless the defensive rule was applied. In that case, the dividends would be taxable with no credit for any imputation credits on the dividends (see Final Report, Example 1.32).

⁴⁹ See sections EX 52(14C) and EX 53(16C), Income Tax Act 2007.

KPMG Comment: It is difficult to follow what exactly is proposed in this section. To the extent it relies on the earlier analysis for FIF investments, the same comments as above apply.

Submission point 5G

Submissions are sought on whether this proposal for amending the income tax treatment of a New Zealand resident who holds shares subject to a hybrid transfer would be a practical response.

Regulatory capital

- 5.59 The UK proposes to take up the option to exclude bank regulatory capital instruments from its regime in certain circumstances (see discussion at Chapter 8 of *Tackling aggressive tax planning* (HM Treasury and HMRC, December 2014). However, we understand that the UK has existing anti-hybrid rules that apply to bank regulatory capital. The Australian Board of Taxation Report sought an extension of time to report on this issue.
- 5.60 It is not proposed that bank regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

KPMG Comment: See the comments above regarding the likely increased cost to New Zealand of applying the hybrid rules to bank regulatory capital. This is due to the likely lower rate that applies to hybrid capital and that its replacement would be debt and not equity for the New Zealand branch.

At a minimum, implementation of the hybrid rules should be deferred until Australia decides on its approach and its rules are confirmed. Australia's approach may make any inclusion of bank regulatory capital moot.

Submission point 5H

Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital.

- 5.61 The exemption of an instrument from the hybrid rules in one country does not require exemption of that same instrument by others (Final Report, page 11). A decision by a country not to fully implement the rules is not intended to bind other countries in their own implementation. That is true even in an area where non-implementation is an option provided by the Final Report. Whether it is

intended or not, a hybrid mismatch causes the same loss of overall tax revenue, and gives rise to the same difficulties of attributing that loss.

Other exclusions

- 5.62 We note that the UK legislation proposes an exception for hybrid transfers to which a financial trader is a party (section 259DD).⁵⁰ The Board of Taxation has recommended that consideration be given to an exception for financial traders entering into repos and securities-lending agreements. It is not clear that sufficient activity of this kind is taking place to justify an exception of this kind in New Zealand.

Submission point 5I

Submissions are sought on whether such an exception is necessary or desirable, and how it should be designed.

- 5.63 New Zealand does not seem to have any entities requiring an exception under Recommendation 1.5 from the primary response. In particular, PIEs are not entitled to a deduction for their distributions, and are not required to distribute their income within any period.

KPMG Comment: New Zealand investors will invest in foreign PIE equivalents who may be seen to have a deduction for distributions made to an investor. We refer particularly to Australian Unit Trusts. From a New Zealand perspective, the Australian entity pays no tax due to it distributing (by the vesting income in beneficiary rules) to investors who are taxed or not.

Investments in such vehicles should be explicitly excluded from the secondary response.

Submission point 5J

Submissions are sought on whether there are any other New Zealand entities that should be eligible for this exemption.

- 5.64 Finally, although the main target of the rule is cross-border transactions, the OECD recommendations can also apply to payments within a country (see Final Report, Examples 1.13 and 1.21). This means that the hybrid financial arrangement rule might deny deductions in purely domestic transactions in some circumstances. However, the focus of the hybrid mismatch rules should

⁵⁰ Section 259DD of Schedule 10 of the Finance (No.2) Bill (United Kingdom).

be on cross-border activity and accordingly it is proposed that domestic transactions are specifically excluded from the application of the rules.

KPMG Comment: *We agree.*

CHAPTER 6

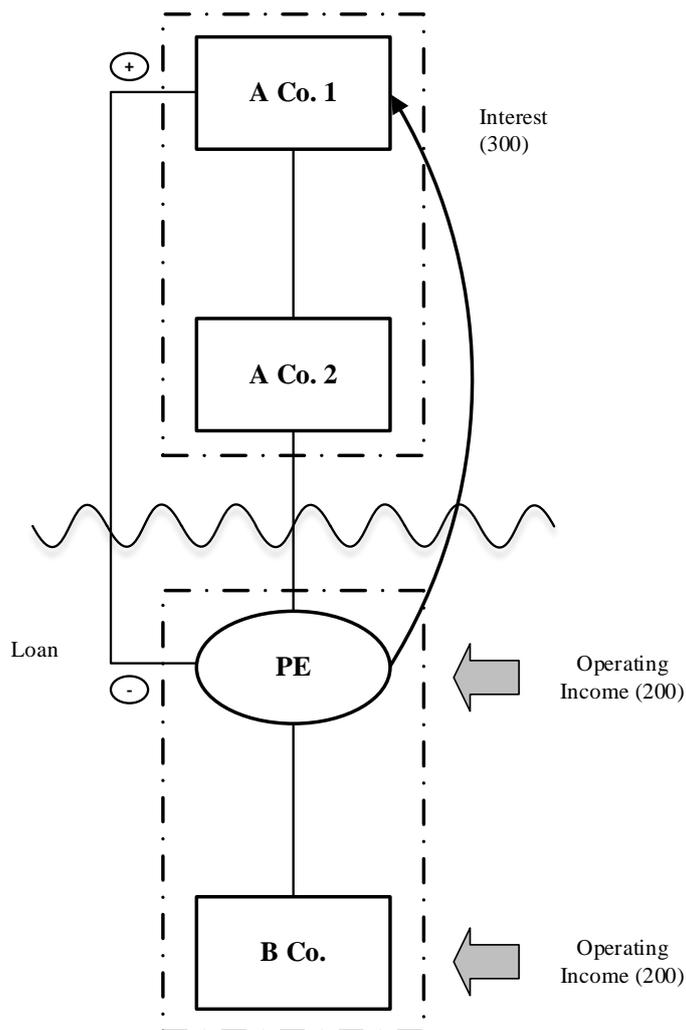
Disregarded hybrid payments

- 6.1 This chapter considers Recommendation 3 of the Final Report; the disregarded hybrid payments rule. The rule applies when a deductible cross-border payment has been disregarded by the payee country due to that country's treatment of the payer. This generally results in a D/NI outcome. This outcome can be counteracted by the disregarded hybrid payments rule through a denial of deduction in the payer country (the primary response), or an inclusion of income in the payee country (the secondary response or defensive measure).
- 6.2 The disregarded hybrid payments rule only applies if the parties to the hybrid mismatch are in the same control group or are party to a structured arrangement (both defined in Chapter 12).
- 6.3 Figure 2.3 in Chapter 2 of this document is an example of a disregarded hybrid payment structure.

Requirements for rule to apply

- 6.4 A disregarded payment is one that is deductible in a country where the payer is a taxpayer (the payer country) and is not recognised as a payment in any country in which the payee is a taxpayer (the payee country).
- 6.5 A hybrid payer is an entity that is treated by the payee country in a manner that results in a payment by the entity being disregarded.
- 6.6 An example of a hybrid payer entity in New Zealand is an unlimited liability company wholly owned by a US parent. The company is fiscally opaque in New Zealand but treated as a foreign branch of the US parent in the US. Accordingly when it makes a payment to its parent, there is a deduction in New Zealand but no inclusion in the US.
- 6.7 The question of whether an entity is a hybrid payer will not turn on a preordained list of entities and no characteristics in and of themselves would qualify an entity as a hybrid payer. Moreover, an entity that is considered to be a hybrid payer in one scenario may not be a hybrid payer under a different scenario. See for instance, Example 3.2 of the Final Report, reproduced below as Figure 6.1.

Figure 6.1: Disregarded hybrid payment using consolidation regime and tax grouping⁵¹



- 6.8 In this case, the election by A Co 1 and A Co 2 to consolidate for tax purposes results in a disregarded payment and the classification of A Co 2 as a hybrid payer. It is the fact of consolidation rather than the particular characteristics of A Co 2 that mean that the company is a hybrid payer.
- 6.9 It is possible for a disregarded payment to arise as a result of a deemed payment between a branch and another part of the same legal entity. In some countries, if funds or an asset, attributable to a foreign entity’s operations in a foreign country is provided to a domestic branch of the same legal entity, the domestic branch is entitled to a deduction for a notional payment for the provision of the funds or asset. If the foreign country does not recognise this payment, there is a disregarded payment.

Dual inclusion income

- 6.10 The disregarded hybrid payment rule will not apply to the extent that the payer’s deduction is offset against income that is dual inclusion income.

⁵¹ OECD 2015 Final Report, Example 3.2, at p293.

- 6.11 Dual inclusion income is ordinary taxable income in the payer country and in the payee country. Dual inclusion income is also relevant to the deductible hybrid payments rule and to the double deduction and dual resident payer rules which are discussed in Chapters 8 and 9 respectively.
- 6.12 The exclusion from the rule for disregarded payments offset by the payer against dual inclusion income recognises that a taxpayer's circumstances may create a tax advantage through a disregarded payment in the payer country which is neutralised by taxation in the payee country. The advantage is neutralised because the payee country taxes the dual inclusion income with no deduction for the disregarded payment.
- 6.13 Differences in the way that each country treats income in terms of timing or valuation will not prevent the classification of an item of income as dual inclusion income. This is demonstrated in Example 6.1 of the Final Report. In that example, different timing rules apply in the payer and parent countries to the calculation of dual inclusion income, which means that different amounts are affected by the hybrid rule depending on whether the primary or defensive rule applies. The payer country's calculation of the dual inclusion income is used to make the primary response whereas the payee country's calculation would be used to make the defensive response.
- 6.14 The Final Report recommends that items that are taxed as income in one country and are subject to a type of double taxation relief in the other country can nonetheless be classified as dual inclusion income.⁵² Dual inclusion income includes an equity return that is:
- taxable in the payee country (whether or not with an underlying foreign tax credit); and
 - granted a tax credit or exemption in the payer country, which is designed to avoid economic taxation.
- 6.15 An example of dual inclusion income that is subject to double taxation relief in one country is Example 6.3 of the Final Report. In that example, a dividend received by a hybrid payer is allowed an intra-group tax exemption in the payer country but is subject to tax in the payee country due to the dividend recipient (hybrid payer) being treated as fiscally transparent in the payee country.
- 6.16 A further example of dual inclusion income is if B Sub 1 in Figure 2.3/6.1 pays an exempt or fully imputed dividend to B Co, provided that dividend is subject to tax in Country A.
- 6.17 Broadly speaking, the effect of allowing a D/NI payment to be deducted against dual inclusion income but then applying Recommendation 3 as to any excess is that to the extent of the D/NI payment, any net loss incurred by or through the hybrid entity:

⁵² OECD 2015 Final Report at para 126.

- is unable to be used to offset any other income in the payer country (primary rule); or
- is unable to be used to offset any other income in the payee country.

The qualification to that statement is that it is only entirely true if all of the income derived by or through the payer entity is dual inclusion income. If some of it is not dual inclusion income, the amount of the D/NI payment that may not be deducted will be increased by that amount.

Example

Take the example in Figure 2.3/6.1. Suppose that the interest payment to A Co is \$300, and that in addition, B Co has \$50 of income and B Sub 1 has \$100 of net income. The \$50 income earned by B Co would *prima facie* be taxable also to A Co, and is therefore dual inclusion income. The \$100 earned by B Sub 1 would not be taxable to A Co and therefore would not be dual inclusion income.

Accordingly, under the primary rule, Country B would deny B Co a deduction for \$250 of the interest. B Co would have no net income or loss, and B Sub 1 would have \$100 income. A Co would have \$50 income.

Under the defensive rule, Country A would tax A Co on \$250 of interest. The result of the defensive rule would be a loss in Country B of \$150 (after offset of \$100 of B Co's \$250 loss against B Sub 1's income), and income for A Co in Country A of \$300 (the \$50 of income earned by B Co plus \$250 under the Recommendation 3 defensive rule).

Carry-forward of denied deductions

- 6.18 Any deduction denied under the disregarded hybrid payments primary rule may be carried forward to a future year to be offset against excess dual inclusion income (that is, dual inclusion income against which a hybrid deduction has not already been taken).
- 6.19 Carry-forward would be subject to the existing continuity of ownership rule that applies to the carry-forward of losses.

Example

Take the example above. Suppose the only event in year 2 is that B Sub 1 pays a dividend to B Co of \$100, which is exempt to B Co in Country B but taxable to A Co in Country A. The dividend is dual inclusion income. If the primary rule applied in year 1, in year 2 \$100 of the \$250 portion of the interest deduction disallowed in year 1 under the primary rule would be deductible to B Co in year 2, giving it a net loss of \$100 in Country B, which it is free to use in accordance with Country B tax rules (for example, it can be grouped with the income of another group member).

However, if the defensive rule applied in year 1, the Final Report does not provide for reversal of the \$250 income recognised by A Co.

Submission point 6A

Submissions are sought on whether there are any issues with using the rules for the carrying forward of tax losses as a basis for the treatment of carrying forward disallowed deductions.

KPMG Comment: The effect of denying the deduction is to treat the expenditure as not incurred or to match that expense against the income that it generates. If the denial of the deduction is principled, there is no reason to subject the expense to a carry-forward rule. It will be properly deducted against the income that it generates. To deny a deduction would be to over-tax when there is no net income to tax.

Application of CFC regimes

- 6.20 The Final Report states (paragraph 127) that an item of income can be dual inclusion income if it is the ordinary income of a company subject to tax in one country and is attributed income for the shareholder of the company in another country under a CFC regime. The Final Report recommends that for a taxpayer to claim an item of income to be dual inclusion income, they must demonstrate to the relevant tax authority that the effect of the CFC regime is that the item of income is subjected to full rates of tax in two countries.

Implementation issues

- 6.21 To calculate its dual inclusion income, a taxpayer must detect all instances where two countries will consider the same item to be included as income. This task could involve substantial compliance costs where a taxpayer has many cross-border payments and where payments are recognised in different ways by the countries. The Final Report suggests that countries should aim to introduce implementation solutions that maintain the policy intent of the rules while reducing the compliance costs that taxpayers may encounter in assessing their dual inclusion income.⁵³
- 6.22 Taxpayers generally prepare accounts of income and expenditure in the countries they operate in. This information could be used as an initial basis for identifying dual inclusion income. A document containing this information with identified dual inclusion income items should be maintained by the taxpayer to support the claiming of a deduction for a D/NI payment (and, if the payer country does not apply the primary rule, non-inclusion of such a payment under the secondary rule).
- 6.23 The Final Report proposes⁵⁴ that, to apply the disregarded hybrid payments rule primary response, the total claimed deductions for disregarded payments would be limited to the extent of the total identified dual inclusion income of the taxpayer. The defensive response would be achieved by requiring payee country entities to recognise income to the extent that deductions claimed in the payer country exceed dual inclusion income.

⁵³ At para 130.

⁵⁴ Example 3.1; paras 13–14.

- 6.24 Another implementation solution suggested by the Final Report (Example 3.2, reproduced in Figure 6.1) is in relation to a consolidated group that crosses two countries (for example, where a member has a branch in another jurisdiction, or where a member is a resident of another jurisdiction). The Final Report proposes that in applying the primary response the payer country could prevent a hybrid payer from using a loss of the payer country consolidated group to the extent that deductions have been claimed in the payer country for payments that were disregarded under the law of the payee country. For the defensive response, the payee country would require a resident entity to include as income the hybrid payer's deductible payments that are disregarded in the payee country to the extent that they result in a net loss (taking into account dual inclusion income) in the payer country. The Final Report further suggests that specific measures would be needed to ensure that the parties involved in a transaction cannot circumvent these rules by allocating non-dual inclusion income to the hybrid payer in order to offset its losses.

KPMG Comment: The principled response is to allow taxpayers to show that income is dual inclusion. In New Zealand's self-assessment regime that would be required in any case.

We would also expect that if existing systems do not already track material amounts that such systems would be developed. This would potentially be in conjunction with systems developed to comply with CbC reporting requirements.

We note that if such evidence is not available a deduction would be denied.

Submission point 6B

Submissions are sought on the practicalities of assessing a taxpayer's dual inclusion income, the feasibility of the implementation options described above, as well as any other implementation solutions for the successful operation of dual inclusion income rules in New Zealand.

Application to New Zealand

Carry-forward/reversal of defensive rule income

- 6.25 The Final Report does not propose a carry-forward rule for the application of the defensive rule. This creates a potential for over-taxation in a scenario where the defensive rule is applied to include extra income in the payee country and excess dual inclusion income arises in a later year.
- 6.26 A solution to this problem may be to provide for a "reversal" rule whereby the application of the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income.

- 6.27 Alternatively, the defensive rule could be limited so that income is only included to the extent that the disregarded payment deduction is offset against non-dual inclusion income in the payer jurisdiction. In the event that there is no non-dual inclusion income that the payment can be offset against, the income inclusion could be suspended until non-dual inclusion income is present. Unlike the reversal approach, this option would require the payee country tax authority and payee jurisdiction taxpayers to be aware of the level of non-dual inclusion income being earned in the payer country.

KPMG Comment: The reversal rule appears easier to apply, subject to the comments above regarding continuity rules.

We note that it is not clear what 6.27 actually proposes.

Submission point 6C

Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in this regard, and which approach would be best to take.

Dual inclusion income

- 6.28 As with Recommendation 1, it is proposed that CFC income is not able to be included as dual inclusion income. This will avoid drafting a large amount of very detailed and targeted legislation, aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise.

KPMG Comment: See our comments above. We consider this proposal unprincipled as it does not attempt to prevent double taxation. CFC income should be able to be included as dual inclusion income.

We agree that the legislation is likely to be complex to be appropriately targeted. The rules should be as clear as possible. Therefore, their implementation may also justify a consolidation and re-write of the CFC and FIF rules which the Finance and Expenditure Select Committee has already recommended.

Submission point 6D

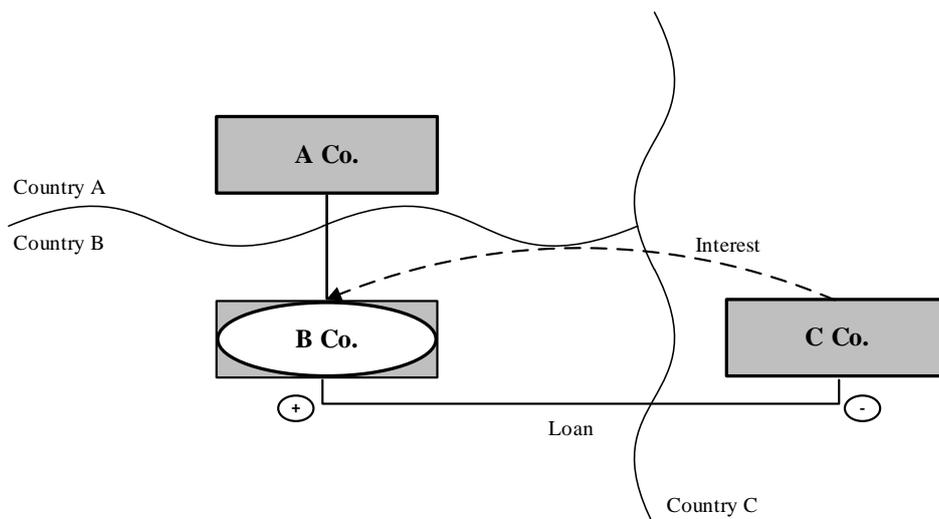
Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in relation to CFC income as dual inclusion income.

CHAPTER 7

Reverse hybrids

- 7.1 A reverse hybrid is an entity where some or all of whose income is (or can be):
- in its establishment country, treated as derived by its investors (generally its owners); and
 - in an investor country, treated as derived by the entity.
- 7.2 A New Zealand limited partnership may be an example of such an entity. For New Zealand tax purposes, the income of a New Zealand limited partnership is taxable to the partners. However, if a partner is resident in a country that treats the partnership as an entity separate from the partners for its tax purposes (for example, because it has separate legal personality) the partnership is to that extent a reverse hybrid. Look-through companies can also be reverse hybrid vehicles in New Zealand (though recent proposed law changes will limit the ability for conduit income to be earned through a look-through company). A New Zealand trust may also be a reverse hybrid. For New Zealand tax purposes, income which is treated as beneficiary income is taxed to the beneficiary, not the trustee. However, if the beneficiary is resident in a country which does not recognise trusts, the income may not be treated by the beneficiary's residence country as derived by the beneficiary, particularly if it is not actually distributed to the beneficiary.
- 7.3 An example of a reverse hybrid giving rise to a hybrid mismatch is in Figure 2.5 (repeated below from Chapter 2).

Figure 7.1: Payment to a reverse hybrid (repeated Figure 2.5)



Branches as reverse hybrids

- 7.4 When a country does not tax its residents on income from foreign branches, a mismatch of rules between that country and the country where a branch is located can lead to a reverse hybrid result. This can occur if a payment to a person is treated in the residence country as non-taxable because it is attributed to a foreign branch, but in the branch country the payment is also not taxed, because the branch country either:
- does not treat the person as having a branch; or
 - treats the payment as not attributable to the branch.
- 7.5 Accordingly, Recommendations 4 and 5 are also applicable to branches in these situations. The branch is analogous to the reverse hybrid entity, and the head office to the investor.

Recommendation 4

- 7.6 Recommendation 4 is when a D/NI payment is made to a reverse hybrid, and the payment would have been included in income if it were made directly to the investor; the payer country should deny a deduction for the payment. The Recommendation also applies if the payment would have given rise to a hybrid mismatch under the hybrid financial instrument rule if made directly to the investor. As with the disregarded payments rule, this rule can apply to any deductible payment.
- 7.7 Taxation of an investor in its home country on a subsequent distribution by the reverse hybrid of the income does not prevent a payment being subject to disallowance under this Recommendation (Final Report, paragraph 156).
- 7.8 Many trusts – for example, most family trusts, do not have investors as such. For the purposes of this rule, an investor is any person to whom income is allocated by a reverse hybrid. So it would include any person who is allocated beneficiary income.
- 7.9 The Recommendation will not apply if the reverse hybrid establishment country taxes as ordinary income the income allocated to the non-resident investor – for example, on the basis that the reverse hybrid is carrying on business in the establishment country.
- 7.10 The rule only applies if either:
- the investor, the reverse hybrid and the payer are members of the same control group; or
 - the payment is under a structured arrangement to which the payer is a party.
- 7.11 The definitions of a control group and a structured arrangement are in Chapter 12.

7.12 There is no defensive rule for reverse hybrids. This is on the basis that if a country adopts Recommendation 5, there is no need for a defensive rule.

Recommendation 5

7.13 Recommendation 5 contains three further recommendations regarding tax rules for reverse hybrids as follows:

- Countries should ensure that their CFC and other offshore investment regimes are effective to prevent D/NI outcomes arising in respect of payments to a reverse hybrid in which their residents are investors.
- Countries should tax reverse hybrids established in their own country to the extent that their income is allocated to non-residents who are not taxable on the income because they are resident in a country that treats the reverse hybrid as fiscally opaque. This recommendation would only apply if the non-resident investor is in the same control group as the reverse hybrid.
- Countries should introduce appropriate tax filing and information reporting requirements on tax transparent entities established within their country in order to assist non-residents and tax administrations to determine how much income has been attributed to their investors.

7.14 The proposed application of Recommendations 4 and 5 in New Zealand is considered below.

Application in New Zealand

Recommendation 4

7.15 From a New Zealand perspective, it will be New Zealand payers rather than New Zealand payees who are affected by New Zealand legislating for this recommendation. There do not seem to be any particular New Zealand-specific issues raised by Recommendation 4 that have not already been discussed in relation to the other Recommendations. Implementing the rule will simply involve denying a deduction if the necessary conditions are satisfied.

KPMG Comment: As above generally and relevant.

Submission point 7A

Submissions are sought on whether there are any issues relating to implementing Recommendation 4 in New Zealand.

- 7.16 From the perspective of other jurisdictions making payments to New Zealand, we note that a foreign investor PIE would seem to be a reverse hybrid, depending on the treatment of the investors in their home countries (see Final Report, paragraphs 161 and 162). However, a payment to a foreign investor PIE would not be subject to disallowance in most cases, due to the scope limitation of Recommendation 4.

***KPMG Comment:** This conclusion seems to be contrary to the comment above regarding deductions for PIEs. It also ignores the technical answer that the PIE is in fact taxable on the payment made, it is simply taxed at a “nil” rate. This is a specific policy decision. It highlights the need to determine whether the result is a hybrid outcome or a deliberate “exemption”. The foreign investor is not taxed or looked through to under the New Zealand tax rules.*

We refer above to our concerns regarding the scope of the structured arrangement definition. We consider that the last sentence is not clearly correct.

Recommendation 5.1: CFC and other offshore investment regimes

- 7.17 This recommendation is for New Zealand to ensure that a payment to a CFC that is fiscally transparent in its establishment country with respect to the payment is caught by the CFC regime, that is, that it is taxed to New Zealand investors in the CFC, if those investors are subject to tax under the CFC regime. In this way, the CFC regime would be used to turn the reverse hybrid into an ordinary fiscally transparent entity, at least insofar as it allocates income to New Zealand investors.
- 7.18 One way to address this would be to treat any person who has an interest in a CFC, as determined under subpart EX, to derive an amount of income from the CFC equal to the amount allocated to that person by the reverse hybrid for income tax purposes in its establishment country, and which is not taxed in the establishment country because of that allocation. This figure will already have been calculated by the CFC, and so should be readily available to the investor. In the case of an entity that is only partially transparent only the untaxed income would be subject to the CFC regime.
- 7.19 This is the approach suggested in paragraph 173 of the Final Report. It would override the rules which generally apply to the calculation of CFC income. In particular:
- attribution would not be limited to the types of income specified in section EX 20B, being generally passive or base company income;
 - the exemption for non-attributing Australian CFCs would have to be amended such that reverse hybrid entities established in Australia would be excluded from the exemption;
 - the amount of income taxable in New Zealand would be determined under the tax rules of the establishment country, rather than under New Zealand tax rules. This is different from the approach taken for foreign entities which New Zealand treats as fiscally transparent – for example,

foreign general partnerships. An investor's taxable income in such entities must be calculated under New Zealand income tax rules. While this ensures that income from foreign sources is determined in the same way as income from domestic sources, it does require an additional element of compliance, and can lead to either double taxation or double non-taxation, either on a temporary or permanent basis; and

- the amount allocated to an investor would not be determined by reference to the investor's income interest as calculated under New Zealand tax rules, but by reference to the investor's percentage share of the entity's income as determined by the rules of the establishment country (though the two would usually be the same or very similar).

KPMG Comment: *This section does not clearly detail the interaction with the active income exemption. It appears to suggest that the active income exemption would be overridden if the CFC's income is attributed to the New Zealand investor. It is not clear why such an override is required (given that it would not be taxed in New Zealand).*

7.20 This recommendation would also apply to the attributable foreign income method under the foreign investment fund (FIF) regime. It would not seem necessary to apply it in relation to the other FIF methods, which already tax on an accrual basis. While there are certain exemptions from the FIF regime, these do not seem to be available to a reverse hybrid, because all of them require that the non-FIF entity is liable to tax either in Australia or in a grey list country. This requirement might need to be modified to ensure that the exemptions are not available to partially transparent entities.

7.21 Trusts established in a foreign jurisdiction with a New Zealand resident settlor are already fully taxable, that is, it is not possible for such a trust to be a reverse hybrid. However, if a payment received by a foreign or non-qualifying trust which has foreign trustees is:

- attributed to a New Zealand beneficiary under the laws of that foreign country and therefore not taxed in that country; and
- not taxed by New Zealand, for example, because it is treated by New Zealand as trustee income that is not subject to New Zealand tax, the foreign trust is to that extent a reverse hybrid.

KPMG Comment: *It is not clear that this can be achieved under New Zealand's trust laws. New Zealand treats an amount as beneficiary income if it was paid or applied to the beneficiary. It is not clear what foreign rule would be broader than this rule so that it was treated as beneficiary and not trustee income. (We would expect the reverse to apply.) Further, if there were such a gap, the payment when made to the beneficiary, as sourced from trustee income, would be a taxable distribution. The document's concern seems to be theoretical.*

- 7.22 The mismatch could be resolved by treating such a payment as beneficiary income for New Zealand tax purposes. This should not be problematic from an administrative perspective, since the records of the trust in the establishment country would generally reflect in some way the allocation of the income to the beneficiary.
- 7.23 Alternatively, New Zealand could depart from the OECD's approach and achieve the intention of Recommendation 5.1 through a different type of rule.
- 7.24 The UK has drafted a narrower rule than that in Recommendation 5.1. Its rule includes an amount in the income of a UK investor which is derived through a reverse hybrid only to the extent of a D/NI mismatch in respect of a payment to the reverse hybrid that is not counteracted in another jurisdiction.⁵⁵ This rule resembles the "defensive" parts of other OECD recommendations, such as the hybrid financial instrument rule (Recommendation 1) and the disregarded hybrid payments rule (Recommendation 3). However, this rule is more complex in that it requires the investor to determine whether or not a particular payment has given rise to a D/NI outcome and whether or not that has already been counteracted.
- 7.25 Australia already has a set of rules that seek to counteract mismatches arising from reverse hybrid entities established in other countries.⁵⁶ These rules provide that a specified list of foreign entities are treated as partnerships under Australian law to the extent that they are tax-transparent in their establishment jurisdiction. The rules therefore link the tax treatment in Australia to the overseas tax treatment and ensures that the untaxed income of the foreign entity will flow through to its Australian investors on an apportioned basis.

KPMG Comment: Consistent with our view, this appears to be a more principled approach as it goes part way to aligning definitions of opaque/transparent treatment of entities.

However, we note the difficulty with this approach is that it imports definitions without subjecting them to the consultative process.

We consider a better approach would be to agree with Australia a common definition of opaque/transparent entities which could be included in New Zealand's domestic law.

- 7.26 New Zealand taxes residents on the income they derive through foreign branches, so Recommendation 5.1 does not require any change in that respect.

KPMG Comment: The document does not appear to have any regard to the questions that arise in chapter 8 for foreign branches. It supports our view that the proposals, because of their breadth and the lack of coordination, risks creating an incoherent New Zealand tax regime.

⁵⁵ Section 259GD, Schedule 10, Finance (No. 2) Bill 2016.

⁵⁶ Division 830, Income Tax Assessment Act 1997.

Submission points 7B

Submissions are sought on whether it would be best for New Zealand to:

- follow the OECD's Recommendation 5.1 and amend its CFC rules as discussed above; or
- adopt a more limited approach as in the UK; or
- link the New Zealand tax treatment of income earned through a foreign entity to the treatment in the jurisdiction where that entity is established, as Australia has done on a limited basis.

If the OECD approach is to be followed, how could New Zealand's CFC regime best be adapted to impose New Zealand tax on income allocated to a New Zealand resident by a reverse hybrid?

Submissions are also sought on the desirability or otherwise of changes to New Zealand's trust and FIF regimes for the purpose of implementing Recommendation 5.1.

Recommendation 5.2: Taxation of reverse hybrids established in New Zealand

7.27 Under this rule New Zealand would tax the foreign source income of (for example) a New Zealand partnership as if it were a company, to the extent that income is allocated to a non-resident 50 percent partner who treats the partnership as fiscally opaque. The ownership threshold is necessary to the example because the scope of the recommendation is limited to investors who are in the same control group as the reverse hybrid. If New Zealand turned off its transparency in this kind of case, neither payer nor investor country would need to apply their reverse hybrid rule to that payment. This approach would also apply to payments that are not deductible (and therefore not subject to Recommendations 4 or 5.1). A dividend paid by a foreign company to a New Zealand partnership with a majority foreign owner who treats the partnership as exempt would be subject to New Zealand tax on the same basis as if the partnership were a company.

7.28 This rule could apply to limited and general partnerships, and to foreign investor PIEs, to the extent those entities derive foreign sourced income which is allocated to foreign investors. It could also apply to a New Zealand foreign trust (a trust with a New Zealand trustee but no New Zealand settlor, and usually no New Zealand assets), to the extent that the trust allocates foreign income as beneficiary income to a non-resident beneficiary in the same control group as the trust.

7.29 There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand's right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply

Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.

7.30 The definition of a “control group” is discussed in more detail in Chapter 12. The definition is designed to apply to partnerships and trusts as well as to corporate groups. Example 11.1 of the Final Report demonstrates that:

- the power to appoint a trustee of a trust is treated as a voting interest in the trust;
- where a settlor’s immediate family are the beneficiaries of a trust, they will be treated as holding equity interests in the trust, and these equity interests will be deemed held by the settlor under the “acting together” test.

7.31 This rule also suggests that New Zealand should tax the non-New Zealand source income of a non-resident if the non-resident’s home country:

- treats the income as attributable to a New Zealand branch; and
- on that basis, exempts it from tax.

KPMG Comment: The treatment of a foreign trust has been recently considered by the Independent Review of New Zealand foreign trusts. It concluded that New Zealand’s principled approach is correct. We see no reason to depart from that conclusion.

We further note that a “New Zealand foreign trust” is not defined. See our submissions on the Taxation (Business Taxation, Exchange of Information and Remedial Matters,) Bill. The scope of this change is potentially significant.

Submission points 7D

Submissions are sought on whether and to what extent reverse hybrid entities established in New Zealand should (or should not) become taxable on their income under the principle of Recommendation 5.2. In particular, should trustee income earned by a New Zealand foreign trust be subject to New Zealand tax if the requirements of Recommendation 5.2 are met?

Submissions are also sought on the proposal to tax income treated by another jurisdiction as attributable to a New Zealand branch, and accordingly not subject to tax, as taxable in New Zealand, even if it otherwise would not be.

KPMG Comment: There does not appear to be any detailed discussion of the latter proposal?

Recommendation 5.3: Information reporting

7.32 Recommendation 5.3 is that countries should have appropriate reporting and filing requirements for tax transparent entities established in their country. This involves the maintenance by such entities of accurate records of:

- the identity of the investors (including trust beneficiaries);
- how much of an investment each investor holds; and
- how much income and expenditure is allocated to each investor.

7.33 Recommendation 5.3 states that this information should be made available on request to both investors and the tax administration.

7.34 Naturally, New Zealand's record-keeping and reporting requirements are focussed on ensuring compliance with the obligation to pay New Zealand tax. They are not generally designed to provide information regarding the derivation of income that New Zealand does not tax. However, the requirements vary. Taking the simple example of a tax transparent entity which is established under New Zealand law but has no New Zealand owners or assets:

- For a general and a limited partnership, there is a requirement to file an IR7 and also an IR7P. The IR7 requires overseas income to be recorded, and the IR7P requires the partners to be identified and the allocation of income to them. This seems to satisfy the requirements of Recommendation 5.3.
- A look-through company is subject to the same record keeping and return filing requirements as a New Zealand partnership. It also must allocate its income and deductions between its owners (Tax Administration Act, section 42B(2)).
- For a New Zealand foreign trust (one where the settlor is not New Zealand resident), the trust is required to keep records allowing the Commissioner to determine its financial position (Tax Administration Act, section 22(2)(fb) and (m)). It must keep records of settlements made on and distributions made by the trust. It is also required to keep particulars of the identity of the settlor and distributees, if known (Tax Administration Act, section 22(7)). The trust also has to provide the identifying particulars of the trust and the address of the New Zealand resident trustees (Tax Administration Act, section 59B). There does not seem to be any requirement for the trust to file a tax return if it has no New Zealand source income.
- For a foreign investor PIE, a return must be filed in the prescribed form (TAA section 57B). In order for foreign investors to not be subject to New Zealand tax at 33% (***KPMG Comment: Note should be 28%?***) on the PIE's foreign income, they must provide to the PIE their name, date of birth, home address, and tax file number in their home country and New Zealand (Tax Administration Act, section 28D).

7.35 With the exception of trusts, New Zealand seems to already be compliant with Recommendation 5.3. The record-keeping and disclosure requirements for New Zealand foreign trusts was separately dealt with by the Government Inquiry into Foreign Trust Disclosure Rules, released on 27 June 2016.⁵⁷

KPMG Comment: We can see no justification for further changes beyond those already proposed for foreign trusts and by the application of the Automatic Exchange of Information rules for investors generally.

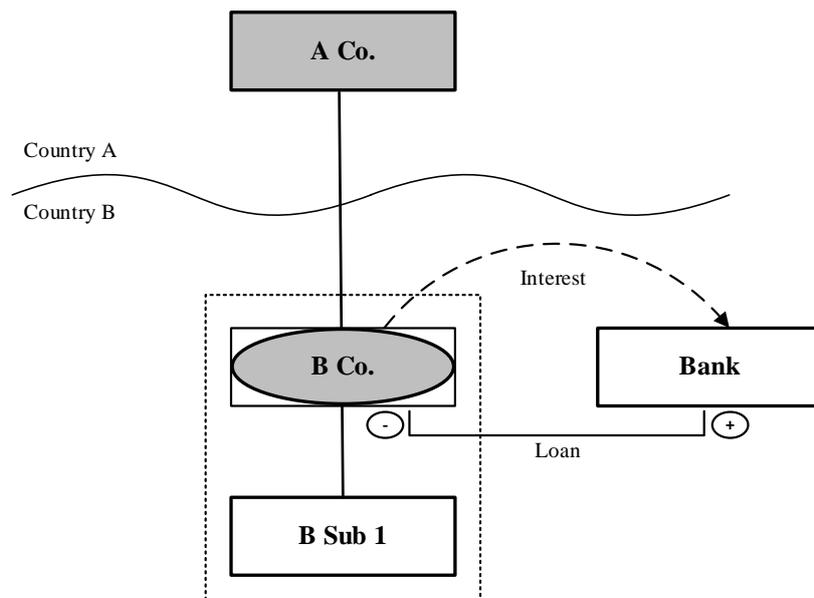
⁵⁷ <http://www.treasury.govt.nz/publications/reviews-consultation/foreign-trust-disclosure-rules>

CHAPTER 8

Deductible hybrid payments

- 8.1 Recommendation 6 concerns payments that are deductible in two countries. A simple example is a payment made by a company's foreign branch. If the company is resident in a country that, like New Zealand, taxes foreign branch income, this payment will often be deductible both in the branch country and in the residence country. The same outcome arises if expenditure is incurred by an entity which is fiscally transparent in a country where one or more of its owners is resident (such as a New Zealand unlimited liability company with a US owner).
- 8.2 To the extent that such a payment is deducted in one country against income that is not taxed in the other country, the payment produces double non-taxation. This is shown in Figure 2.4, reproduced below.

Figure 8.1: DD arrangement using hybrid entity (repeated Figure 2.4)



- 8.3 The primary response in Recommendation 6 is for the parent country to deny a deduction for the payment, to the extent it exceeds dual inclusion income (income taxed in both countries). The parent country is the country where the payer is resident (in the case of a branch), or where an owner of the payer is resident (in the case of a hybrid entity). There is no limitation on the scope of this rule.
- 8.4 The secondary response (which applies only to deductions that are not subject to the primary response) is for the payer country to deny a deduction for the payment, to the extent it exceeds dual inclusion income. The defensive rule applies only if either the payer is a branch, the owner and the payer are in a control group, or the payer is party to a structured arrangement.

- 8.5 Where a foreign tax credit is available in the parent jurisdiction in relation to an item of dual inclusion income, the Final Report proposes that the foreign tax credit can only be used to the extent of the tax liability in the parent jurisdiction on the net dual inclusion income (dual inclusion income less deductions) that arises. This is discussed in Example 6.4 of the Final Report, in particular paragraphs 13 and 14.

Application to New Zealand

- 8.6 The primary response means that in most cases a New Zealand resident will not be able to claim an immediate deduction for a foreign branch loss except against income from the same country. This is because in most cases it will be possible for those losses to be used to offset non dual-inclusion income in the branch country. Unless it can be shown that such an offset is not possible, those losses will have to be carried forward and used either:
- to offset net income from the branch in future years;
 - without restriction, if the losses have become unusable in the branch country, for instance because the branch has been closed down before the losses have been used or because of an ownership change. In this case the losses are referred to as “stranded losses”.
- 8.7 This denial extends to all forms of deductions – for example, it applies to depreciation and amortisation (Final Report, paragraph 192). It only applies to expenditure which is actually deductible. Thus, it will not apply to expenditure for which a deduction is denied under (for example) Recommendation 1 or Recommendation 4.
- 8.8 The secondary response will require New Zealand to introduce a rule denying both New Zealand branches of non-residents and non-resident owned New Zealand hybrid entities the ability to deduct expenditure against income which is not also taxable in the parent country, if that expenditure is not subject to the primary response in the parent country. Most obviously, this will deny such branches or entities the ability to group a loss against the profit of a commonly owned New Zealand entity (unless that entity is also a hybrid whose income is taxable in the parent country). It will also deny them a deduction for their expenditure against their own income if that income is for some reason not taxed in the parent country. An example is income earned through a reverse hybrid (see Example 6.1 of the Final Report).
- 8.9 As discussed in paragraph 200 and Example 6.5 of the Final Report, where the secondary response applies but the owner who is claiming a deduction in the parent country does not own all of the payer, the hybrid rules require the inclusion, in the payer country, of more than the amount which is deductible in both countries. This is necessary so that the amount of additional income allocated to that owner is sufficient to reverse the deduction.

KPMG Comment:

Foreign branch

There is merit in considering an exemption for active income of a foreign branch. We note that this has been on New Zealand's tax policy agenda for some time but has not been progressed.

It has the advantage of equalising the treatment of a CFC and a foreign branch.

We further note that it may eliminate the need for the proposals in chapter 7.

Amount denied

The comments at paragraph 200 and the example at 6.5 are not clear.

Submission points 8

Submissions are sought on whether the denial of a deduction for foreign branch losses against New Zealand income should be matched by an exemption for active income earned through a foreign branch. This would put foreign branches of New Zealand companies in a similar New Zealand tax position to foreign subsidiaries.

Submissions are also sought on any other aspect of the proposals relating to implementation of the OECD's Recommendation 6 in New Zealand.

CHAPTER 9

Dual resident payers

- 9.1 Recommendation 7 applies to dual resident entities. It is similar to Recommendation 6, in that it deals with a situation where a single payment is deductible in two countries. However, in this case there is only one entity involved, and both countries regard it as a resident. Since it is not easy to differentiate between the two countries, Recommendation 7.1 is for both countries to deny the deduction to the extent that it is offset against non-dual inclusion income. As with Recommendation 6, any deduction that is disallowed can be offset against dual inclusion income arising in a later period.
- 9.2 Since only one taxpayer is involved, there is no limitation on the scope of Recommendation 7.
- 9.3 If both residence countries have hybrid rules, it is possible for the disallowance to give rise to double taxation – for example, if it is offset against non-dual inclusion income in both jurisdictions (see Final Report, Example 7.1). However, given that dual residence status is in most cases deliberate rather than accidental, it should be possible for taxpayers to be aware of the possibility of double taxation, and by adopting simpler structures, avoid it.

Application to New Zealand

- 9.4 New Zealand already denies a dual resident company the ability to use a loss to offset the income of other group companies (section IC 7(2)) and to join a tax consolidated group (section FM 31). While this substantially limits the kinds of structures that can give rise to double non-taxation using a dual resident company resident in New Zealand, it does not mean that there are no such opportunities. For instance, New Zealand could not be Country A in the Final Report's Example 7.1, but it could be Country B.

KPMG Comment: *It is not clear how New Zealand being Country B could advantage the group in the example. A Co 2 must by definition be dual resident in New Zealand and Country A. This would generally prevent it offsetting the funding loss against BCo's profit. (We assume the operating income amounts should be positive rather than negative in the Example 7.1.)*

It does not appear that anything is required.

- 9.5 The dual resident payer rule raises a number of issues that have been considered in previous chapters. In particular:
- because a deduction is allowed to the extent of dual inclusion income, dual inclusion income needs to be defined – this is considered in Chapter 6;

- determining whether or not a payment is deductible in the other country may require that issue to be determined earlier than when a deduction arises in that country, in which case the ordinary rules applying in that country should govern the question. At the same time the question requires certain entity specific rules in that country to be taken into account;
- the rule can sensibly apply to non-cash deductions such as depreciation and amortisation. Accordingly it is not necessary to restrict it to payments;
- some equity returns that are tax exempt or tax credited on the basis that they are paid out of tax paid income should still be treated as dual inclusion income;
- disallowed amounts should be able to be carried forward and offset against dual inclusion income arising in a later year. Carry-forward will be limited in the same way as it is limited for losses;
- attributed income under CFC rules cannot be treated as dual inclusion income;
- credit for underlying foreign taxes may be limited; and
- if an entity is unable to carry forward its disallowed loss in one country, the other country can allow the loss to be deducted (see Final Report, Example 7.1 paragraph 13).

Submission point 9A

Submissions are sought on the OECD's Recommendation 7 and any issues that may arise in relation to its implementation in New Zealand.

DTA dual resident rule suggestion

- 9.6 In Chapter 13 of the Final Report it is suggested that countries should consider inserting into their domestic law a rule that deems an entity not to be resident if that entity is resident of another country through the operation of a DTA.⁵⁸
- 9.7 If incorporated into New Zealand law, this rule would prevent an entity benefitting from a mismatch between New Zealand's domestic law definition of residence and the definition of residence found in any of New Zealand's bilateral DTAs.
- 9.8 Canada⁵⁹ and the UK⁶⁰ have domestic law to this effect. New Zealand law currently features a series of provisions that ensure that an entity that is non-resident under a DTA cannot access various features of the New Zealand tax

⁵⁸ At para 432.

⁵⁹ Section 250(5) of the Income Tax Act 1985 (Canada).

⁶⁰ Section 18 of the Corporation Tax Act 2009 (United Kingdom).

system (such as maintaining an imputation credit account).⁶¹ However, New Zealand's rules are not comprehensive, which potentially allows room for abuse. In particular, a company could manipulate its place of effective management under a DTA to avoid New Zealand's corporate migration rules (as they do not provide for a company becoming non-resident under a treaty).

***KPMG Comment:** The non-application of the company emigration rules to residency under a DTA was deliberate. There is no analysis to justify a departure from that rule.*

The broader consequences of deeming a non-resident under a DTA to also be non-resident under domestic law is not considered.

For example, a number of New Zealand's DTAs would not protect distributions by such a company of New Zealand sourced income. See article 10, paragraph 8 of the Australia DTA as an example. This would seem to apply to allow New Zealand to tax what would be taxed under the company emigration rule when the distribution is made.

By contrast, deeming such a company to be non-resident would prevent future New Zealand taxation of distributions of New Zealand sourced income. This may be the right outcome as a dual resident is not able to maintain an ICA and a shareholder would be double-taxed as a result.

Submission point 9B

Submissions are sought as to the OECD's DTA dual resident rule suggestion.

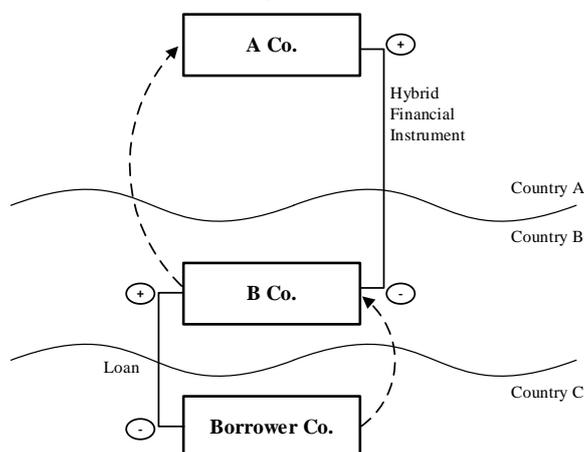
⁶¹ See, for instance, sections FN 4, FO 3, HA 6, IC 7, and OB 1 of the Income Tax Act 2007.

CHAPTER 10

Imported mismatches

- 10.1 Recommendation 8 in the Final Report relates to imported mismatches. It requires a country to deny a payer a deduction for a payment (an *imported mismatch payment*) which meets all of the following requirements:
- is made to a payee in a country that does not have hybrid mismatch rules;
 - does not itself give rise to a hybrid mismatch;
 - which the payee sets off against a *hybrid deduction*, that is, a deduction for a payment that gives rise to a hybrid mismatch, or a deduction for a payment made to a third person which is offset by that third person against a payment giving rise to a hybrid mismatch.
- 10.2 The rule only applies if the payer is in the same control group as the parties to the hybrid mismatch, or the arrangement is a structured arrangement to which the payer is a party.
- 10.3 The rule is not limited to payments in relation to financial instruments. There is no defensive rule requiring inclusion by payees.
- 10.4 The objective of the rule is to increase the effectiveness of the hybrid rules. Importantly, the rule will not apply to a payment to a person in a country that has implemented hybrid rules.
- 10.5 The imported mismatch rule is potentially complex to apply. It will require knowledge of the tax consequences of a wide range of transactions within a group. On the other hand, if a group is structured in a straightforward way, and monitors the existence of hybrid mismatches in intra-group transactions, it is likely that the necessary information will be readily available.
- 10.6 Figure 2.6 (in Chapter 2 of this document) contains a simple example of an imported hybrid mismatch in a structured arrangement, and is reproduced again here.

Figure 10.1: Imported mismatch from hybrid financial instrument (repeated Figure 2.6)



10.7 The arrangement involves A Co providing financing to B Co by way of a hybrid financial instrument, with B Co then lending that money to Borrower Co in Country C. Suppose that Country C is the only one with hybrid rules. Leaving aside the imported mismatch rule, the result of the arrangement is:

- a deduction for Borrower Co;
- no net income to B Co (because its income from the loan equals its deduction on the hybrid instrument); and
- no income to A Co (because Country A treats the financing as equity and does not tax the dividend).

The overall outcome is double non-taxation.

10.8 Accordingly, under the imported hybrid mismatch rule, Borrower Co would be denied a deduction for the lesser of its interest payment and the interest payment by B Co.

Non-structured imported mismatches

10.9 Final Report Examples 8.3 to 8.9 in particular demonstrate the application of the direct and indirect imported mismatch rule. These rules apply to payments within a control group. They apply when a payment is made by a payer in a country with hybrid rules to a payee in a country without hybrid rules, to the extent that payee is:

- a payer under a hybrid mismatch (in which case there is a direct imported mismatch); or
- a payer to a payee who is in turn a payer under a hybrid mismatch (in which case there is an indirect imported mismatch).

Application to New Zealand

10.10 As it is part of the OECD recommendations, it is proposed that New Zealand should introduce an imported hybrid rule. Multinational groups with Australian or UK members will already need to be keeping track of uncorrected hybrid mismatches for the purpose of compliance with the rules in those countries, so the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context.

KPMG Comment: *The document does not refer to other jurisdictions and their requirement, or otherwise, to maintain the relevant documentation. There will be additional compliance for multi-national groups with no Australian or UK presence.*

Refer to our comments on “control group”. A control group is wider than a parent-subsidiary relationship. Given this wider definition, access to information is likely to be problematic.

- 10.11 Accordingly, an imported mismatch rule that is introduced in New Zealand should, so far as possible, be consistent with the rules adopted by the UK and Australia. For instance, the Australian Board of Taxation has noted that a de minimis/safe harbour test may be appropriate for the imported mismatch rule in Australia.

KPMG Comment: We refer to our earlier comments on the justification for the hybrid rules generally.

We further note that adopting this recommendation implies that the hybrid recommendations would not be widely adopted. (It appears to apply because intermediate countries have not adopted hybrid rules.) This appears to weaken the justification for New Zealand’s implementation – that global adoption will benefit New Zealand.

This recommendation should not be immediately pursued. It will require complicated legislation and compliance will be difficult.

It is therefore better to see if it is required if global implementation does not occur.

Submission point 10

Submissions are sought on whether New Zealand should adopt an imported mismatch rule as recommended by the OECD, and what matters may need to be considered in order to ensure that the rule works as intended, with compliance costs reduced so far as possible.

CHAPTER 11

Design principles, including introduction and transitional rules

- 11.1 Final Report Recommendation 9 contains recommendations for:
- the design of the hybrid rules, including their interaction with other parts of the legislation, and
 - introduction and transitional issues, and how countries should implement the hybrid rules.

Design and interaction

General

- 11.2 Most of the design principles in Recommendation 9 are uncontroversial, and it is proposed that they would be utilised if the OECD recommendations were adopted in New Zealand. Adhering as closely as possible to the OECD recommendations is more likely to create rules that are:
- Comprehensive. This is important so that the rules do not leave open or create hybrid planning opportunities, while imposing unnecessary compliance costs.
 - Consistent with those adopted by other countries. This will go some way to creating a single set of rules, so that the rules do not give rise to unintended gaps or overlaps, and anyone who is familiar with hybrid rules in one country will have a good idea of how they work in another. Nevertheless, some variations between countries are inevitable.

Ordering of hybrid rules

- 11.3 As recommended in the Final Report (paragraph 286), it is proposed that the OECD recommendations would apply in the following order if implemented in New Zealand:
- hybrid financial instrument rule (Recommendation 1)
 - reverse hybrid rule (Recommendation 4) and the disregarded hybrid payment rule (Recommendation 3)
 - imported mismatch rule (Recommendation 8)
 - deductible hybrid payment rule (Recommendation 6) and the dual resident entity rule (Recommendation 7).

Interaction of hybrid rules and withholding tax

- 11.4 In accordance with the OECD recommendations, we propose that denial of a deduction for a payment under any of the hybrid rules would not affect its withholding tax treatment.

KPMG Comment: See our comments above. We consider the OECD recommendation is unprincipled as it will lead to double taxation. For New Zealand to proceed with that rule perpetuates an unprincipled approach. This is especially the case for deductions which are deferred pursuant to an arbitrary time limit.

We consider that as the hybrid rules are targeted (they apply to particular instruments and entities with particular cashflows), New Zealand's withholding tax rules should be modified if the proposals proceed.

Interaction of hybrid rules and transfer pricing

- 11.5 It is proposed that taxpayers are able to apply the hybrid rules in priority to the transfer pricing rules. This will ensure that to the extent a payment is disregarded under the former, there is no need to undertake a transfer pricing analysis.
- 11.6 When a New Zealand taxpayer is required to include an amount in income under Recommendations 1, 3 or 4, the amount included would be net of (reduced by) any transfer pricing adjustment in the payer country.

Interaction of hybrid rules and thin capitalisation

- 11.7 Where a deduction is disallowed for an amount of interest under the primary rule in Recommendation 1, or under Recommendations 4 or 8, it is proposed that the thin capitalisation rules be applied on the basis that the disallowed interest and the debt relating to that interest are both disregarded. This will produce the same result as if the interest was a dividend and the debt was equity. It will prevent any double deduction denial of the same payment.
- 11.8 The interaction with thin capitalisation rules and Recommendations 3, 6 and 7 is more complex due to the carry-forward rule which has no equivalent in New Zealand's thin capitalisation regime. Due to the carry-forward rule, if the disregarded hybrid payments rule applies before thin capitalisation, a permanent deduction denial under thin capitalisation could be replaced by a deduction denial under anti-hybrid rules which may be reversed by the carry-forward rule in a later year (due to excess dual inclusion income).
- 11.9 To address this problem without giving rise to double denial of interest expense, it is proposed that the carry-forward rule is limited such that the amount of denied deductions able to be carried forward is reduced by the amount of adjustment that would have occurred under thin capitalisation rules if there was no hybrid counteraction. With this limitation, the hybrid rules can apply before thin capitalisation and the intended result of New Zealand's thin

capitalisation rules will be preserved in the event of a carry-forward deduction being allowed in a future year.

- 11.10 In applying the defensive rule in Recommendation 1 or 3, or Recommendation 2, a New Zealand payee should not consider the thin capitalisation adjustments made by a payer jurisdiction. This is the same approach that is applied to a straightforward interest payment received by a New Zealand payee from a foreign payer. The amount of taxable income is not reduced on account of any interest denial in the payer jurisdiction.

KPMG Comment: This approach appears to be overly complex. The simple principle is a denied deduction is not subject to the thin capitalisation rules. The thin capitalisation rules aim to deny otherwise deductible amounts if the taxpayer breaches allowed debt funding ratios.

See our comments above regarding the effect of the denial and carry-forward. It is either a deferral of the incurred rule or a matching rule. In either case, the thin capitalisation rules would apply to confirm or otherwise a deduction allowed at the appropriate time.

- 11.11 Table A sets out the interaction between the hybrid rules and the thin capitalisation and transfer pricing rules.

Table A: Interaction of recommendations with other deduction denial rules

	Recommendation	Transfer pricing	Thin capitalisation
1	Recommendation 1		
1.1	Primary rule – deny deduction in payer jurisdiction.	Primary rule first, and then transfer pricing. Saves having to do a transfer pricing analysis in cases where the deduction will be denied in any case.	Primary rule first, then thin capitalisation rules. When applying thin capitalisation, ignore disallowed interest, and treat hybrid debt as equity. Ensures no double disallowance.
1.2	Secondary rule – income inclusion in payee jurisdiction.	Do not apply hybrid rules to the extent a deduction is disallowed by transfer pricing in payer jurisdiction.	Apply secondary rule regardless of any thin capitalisation disallowance in payer jurisdiction – it is issuer-specific. Result is the same as if the payment were interest under a simple debt. Same applies to non-deductibility due to direct use of borrowed funds – see Final Report, paragraph 28.
2	Recommendation 2		
2.1	Dividend inclusion in payee jurisdiction.	As for Recommendation 1 secondary rule.	As for Recommendation 1 secondary rule.
3	Recommendation 3		

	Recommendation	Transfer pricing	Thin capitalisation
3.1	Primary rule – deduction denial in payer jurisdiction.	Transfer pricing first, then primary rule. Because primary rule allows carry-forward, transfer pricing has to be done anyway.	Primary rule first. However, carry forward reduced to the extent that thin capitalisation would have disallowed a deduction if hybrid rules had not applied. Because primary rule allows carry-forward and thin capitalisation does not, if carry forward is not reduced, deductions will avoid thin capitalisation scrutiny, or have the wrong ratio applied.
3.2	Secondary rule – income inclusion in payee jurisdiction.	Do not apply hybrid rule to the extent a deduction is disallowed by transfer pricing in payer jurisdiction.	As for Recommendation 1 secondary rule.
4	Recommendation 4		
4.1	Primary rule – deduction denial in payer jurisdiction.	Primary rule first, and then transfer pricing. As for Recommendation 1.	Primary rule first, then thin capitalisation. As for Recommendation 1.
5.	Recommendation 5		
5.1	5.1 – improvements to CFC regimes.	Not a linking rule – transfer pricing treatment in payer jurisdiction not relevant – only tax treatment in establishment jurisdiction. But if an interest payment is subject to a transfer pricing adjustment in the payer jurisdiction and we have a treaty with them, the payee could ask for a correlative adjustment.	Not a linking rule – thin capitalisation treatment in payer jurisdiction not relevant – only tax treatment in establishment and owner jurisdictions.
5.2	5.2 – limiting tax transparency for non-resident investors.	As for Recommendation 5.1, except right to a correlative adjustment clearer.	As for Recommendation 5.1.
6	Recommendation 6		
6.1	Primary rule – deny deduction in parent jurisdiction.	As for Recommendation 3 primary rule.	As for Recommendation 3 primary rule.
6.2	Secondary rule – deny deduction in payer jurisdiction.	As for Recommendation 3 primary rule.	As for Recommendation 3 primary rule.
7	Recommendation 7		
7.1	Deny deduction in both jurisdictions.	As for Recommendation 3 primary rule.	As for Recommendation 3 primary rule.
8	Recommendation 8		
8.1	Deny deduction in payer jurisdiction.	As for Recommendation 1 primary rule.	As for Recommendation 1 primary rule.

Submission point 11A

Submissions are sought on the intended approach to manage the interaction of the OECD's recommendations and New Zealand's withholding tax, transfer pricing and thin capitalisation rules.

Interaction of hybrid rules and the CFC regime

11.12 Recommendation 5.1 as it relates to payments to a reverse hybrid is considered in Chapter 7. Recommendation 5.1 also suggests that countries consider introducing or making changes to their offshore investment regimes in relation to imported mismatches.

11.13 One such change, labelled a "modified hybrid mismatch rule", is set out in paragraphs 29 to 33 of the OECD's Final Report on Action 3: Designing Effective Controlled Foreign Company Rules.⁶² The change suggested is that a payment from one CFC to another should be included in CFC income if it is:

- not included in CFC income of the payee; and
- would have been included in CFC income if the parent jurisdiction (the jurisdiction applying its CFC rules) had classified the entities and the arrangement the same way as the payer or payee jurisdiction.

11.14 A more general issue is the extent to which a New Zealand company applying the CFC rules has to determine attributable foreign income when taking into account the application of the hybrid rules.

KPMG Comment: It is not clear that such a rule is required as we would expect that any such income is passive income and already included as CFC income if the active income ratio is breached.

Submission points 11B

Submissions are sought on:

- the desirability or otherwise of this modified hybrid mismatch rule; and
- the interaction more generally between the CFC rules and the hybrid rules.

Hybrid rules and anti-avoidance

11.15 We propose that the rules would apply before (and therefore would be subject to) the general anti-avoidance provision. This will ensure that the hybrid rules, which generally apply automatically and do not have a purpose requirement,

⁶² OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
<http://dx.doi.org/10.1787/9789264241152-en>

cannot be used for a tax avoidance purpose. It is consistent with the way section BG 1 applies to any other tax provision.

KPMG Comment: See our comments above regarding the effect of the introduction of the hybrid rules, and the potential for changes in other countries, to change the analysis for section BG 1 purposes.

Further, the hybrid rules will themselves become part of New Zealand's domestic law. Perversely, despite the expectation that alternative arrangements would be used, the use of an alternative arrangement which ensures the anti-hybrid rules do not apply would appear to be at risk of section BG 1 applying to that alternative.

We accept that this analysis may be circular and unintended. It should be explicitly dealt with to ensure that a lower tax position for an alternative to a hybrid is not at risk of section BG 1 applying.

- 11.16 If New Zealand implements the OECD recommendations, the UK approach⁶³ of having a specific anti-avoidance provision for its hybrid rules should be adopted. This provision would apply to an arrangement which has a more than merely incidental purpose of reducing taxable income by avoiding the application of either the New Zealand hybrid rules or the equivalent rules in a foreign jurisdiction. Taxable income for this purpose would include income taxable in a foreign jurisdiction as well as New Zealand. This reflects the general purpose and approach of the hybrid rules, which is to counteract the double non-taxation of income without any need to determine which country's revenue has been affected. It may be useful to explicitly state, as the UK does, that in determining whether an arrangement does avoid the application of the rules, reference should be made to the Final Report and any document which replaces or supplements it.

KPMG Comment: See comment above. An intended result is that taxpayers use alternative arrangements. This rule would appear to prevent their use.

We note that this is a black letter law approach. The OECD report would suggest that this is not hybrid avoidance. However, we note the uncertain status of the OECD report for New Zealand statutory interpretation as well as our comments regarding the unprincipled approach taken. Both will make the application of the parliamentary contemplation test uncertain. This may encourage Inland Revenue to take and the Courts to accept such arguments.

We further note that examples of what Officials consider are unacceptable avoidance of the hybrids rules is required to determine whether this proposal is valid.

⁶³ See proposed section 259M of TIOPA 2010 (United Kingdom).

Submission point 11C

Submissions are sought on the proposal to include a hybrid rules-specific anti-avoidance rule.

Legislative design

11.17 The Final Report clearly expects countries to draft domestic legislation implementing the rules, rather than simply incorporating all or some of the Final Report directly into domestic law. Nevertheless, the Report will continue to be an important document in interpreting the legislation, to the extent that interpretation requires an understanding of the purpose of the rules.

11.18 It may be possible or desirable in some areas to legislate broad principles, which could be fleshed out by regulations of some kind. Regulations, or some other form of subsidiary legislation, would have the benefit of being:

- more easily able to be changed than primary legislation;
- more flexible in their form. For example, it would be easier to include detailed examples, and to have extended discussion of the examples, in subsidiary legislation.

11.19 Examples of where some form of subsidiary regulation might be appropriate are:

- fleshing out the imported mismatch rules;
- providing detail on the definition and calculation of dual inclusion income;
- determination of the extent to which CFC taxation can be treated as preventing a D/NI outcome;
- resolution of double taxation outcomes resulting from introduction of the rules in New Zealand or a counterparty country – in this case the Commissioner might be given the power to override the rules where they would otherwise give a double taxation result.

KPMG Comment: See our submissions on the regulation making powers proposed in the Taxation (Business Tax, Exchange of Information and Remedial Matters) Bill and SOPs. The ability to use regulations and determinations needs to be clearly established so that their validity can be tested.

We further note that the status of subsidiary legislation in determining Parliament's contemplation for section BG 1 purposes needs to be clearly established. Taxpayers will not wish to be at risk of following a regulation or determination only for Inland Revenue to argue that the application of the subsidiary legislation is contrary to Parliament's contemplation.

Submission point 11D

Submissions are sought on the legislative design proposals set out above.

General rule for introduction

11.20 The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311). Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be. Furthermore, the result achieved by the rules should not generally be a punitive one, rather it involves the loss of an unintended tax benefit. The Final Report also suggests that the rules should generally take effect from the beginning of a taxpayer's accounting period.

KPMG Comment: See our comments above regarding the intended or otherwise granting of a tax benefit and the double taxation effects of denying deductions and applying withholding tax.

See also KPMG's previous submissions on proposals to alter the related party NRWT rules. Alternative arrangements are unlikely to be quickly implemented or readily apparent.

11.21 The Board of Taxation recommended that the Australian rules come into force with respect to payments made on or after the later of 1 January 2018 or six months after enactment. The UK rules come into force for payments made on or after 1 January 2017, which is approximately eight months after the introduction of the Finance Bill which contained the rules.

11.22 The impact of the proposals will in most cases be able to be established now, by reference to the Final Report. We consider that the period from introduction of the relevant legislation to its enactment should give taxpayers sufficient time to determine the likely impact and accordingly the effective date of the legislation should be its enactment date. In accordance with the OECD recommendation, the provisions would then apply to payments made after a taxpayer's first tax balance date following enactment. This is a similar approach to that taken to the implementation of the NRWT anti-deferral rules,⁶⁴ except that in this case there would be no early implementation for post-enactment transactions.

KPMG Comment: We disagree. The proposals are detailed, complex and broad in their application. The consultation time frame has not allowed for comprehensive consideration. It is by no means certain that they should apply or in what form they should apply. Our comments

⁶⁴ In the Taxation (Annual Rates for 2016–17, Closely Held Companies and Remedial Matters) Bill.

illustrate this conclusion. Grand-parenting and a reasonable delay (post-enactment) for their implementation should be considered.

- 11.23 An alternative approach would be the Australian one (application to all payments made or received a fixed period after enactment), which would have the benefit of giving all taxpayers an identical start date for applying the rules.

Submission points 11E

Submissions are sought on whether there are any special circumstances that would warrant departing from the general proposition of no grand-parenting, and whether the proposed effective date is appropriate.

Co-ordination with other countries

- 11.24 Rules will also be needed to deal with different implementation dates by different countries. Issues are raised in particular if one country applies an accrual basis of income or expense recognition while the other applies a cash basis.
- 11.25 For example, suppose a hybrid payment in respect of a hybrid financial instrument is made by A Co to B Co, and Country A does not have the hybrid rules but Country B does. B Co will be taxable on the payment. If Country A then introduces the rules, then A Co will be denied a deduction for its payment under the primary rule and B Co will no longer be taxable on that payment. If both companies are on a cash basis and have the same tax accounting period, there is no issue. However, suppose that the two companies have different tax years. Consider B Co's tax year during which the Country A hybrid rules take effect. Country B will need to tax payments received by B Co during the part of its tax year before the start of A Co's tax year, and not tax those received afterwards.
- 11.26 Example 2.3 in the Final Report concerns a transitional situation where a payer of a deductible/exempt dividend is subject to the primary rule in year two, but in year three the payee country introduces a domestic dividend exemption denial rule, in accordance with Recommendation 2.1. The payer is claiming a deduction on an accrual basis, but the payee is recognising income on a payments basis. The effect of the introduction of the exemption denial rule in the payee country is that the payer is entitled to a full deduction in year 3, and the payee is taxable on the portion of the payment for which a deduction has been claimed. That is less than the entire payment, since a portion of the payment was accrued by the payer in year 2, and was non-deductible due to the primary rule.⁶⁵

⁶⁵ Note that there is an error in the example. B Co's year 4 interest deduction for tax purposes should be 75 and its year 4 taxable income should be 25.

KPMG Comment: We note that this appears to be the only section where the document has any concern for double taxation. The same concern should be applied to the rest of the proposals.

Submission point 11F

Submissions are sought on any particular situations that might require particular care to avoid double taxation, beyond those set out here and in the Final Report. It may be desirable to provide some flexibility for the Commissioner to make discretionary adjustments where co-ordination issues mean that the application of the rules in two countries gives rise to double taxation.

CHAPTER 12

Key definitions

12.1 The last three recommendations in the Final Report are about definitions. Most of the definitions are straightforward and they should be adopted so far as necessary. In this Chapter the question of how some significant definitions might be incorporated into New Zealand law is considered.

Financial instrument

12.2 Recommendation 1 applies primarily to “financial instruments”. Recommendation 1.2(c) is that countries treat as a financial instrument any arrangement where one person provides money to another in consideration for a financing or equity return.

12.3 In New Zealand a financial instrument would include a financial arrangement as defined in subpart EW. However, a number of the exclusions from the financial arrangement definition would not apply.

- Given the purpose of the hybrid rules, a financial instrument would include shares in a company, as defined for tax purposes. It would not include an interest in a vehicle treated as fiscally transparent for New Zealand purposes, such as a partnership or look-through company.
- Variable principal debt instruments would be included.
- The definition should also include annuities, farm out arrangements, share lending arrangements and livestock or bloodstock hire purchases, since all of these seem to have some financing component, and could be entered into in a commercial context.

12.4 It is proposed that the remaining excepted financial arrangements would not be financial instruments. This means that operating leases would be outside the definition, while finance leases and hire purchase agreements would be within it.

Structured arrangement

12.5 The definition of a “structured arrangement” is set out in Recommendation 10 of the Final Report, and discussed in some detail. The core definition is that it is an arrangement where either:

- the hybrid mismatch is priced into the terms of the arrangement; or
- the facts and circumstances indicate that it has been designed to produce a hybrid mismatch.

12.6 Facts and circumstances which would be taken into account in determining whether or not an arrangement has been designed to produce a hybrid mismatch would include whether or not the arrangement:

- incorporates a term, step or transaction used to create a hybrid mismatch;
- is marketed as a tax advantage product where some or all of the tax advantage derives from a hybrid mismatch;
- is marketed primarily to investors in a country where the hybrid mismatch arises;
- contains features that alter the terms if a hybrid mismatch does not exist, for example, a tax gross-up provision; or
- produces a negative return absent the hybrid mismatch.

12.7 To incorporate this definition into New Zealand law, it is proposed to use the existing “arrangement” definition, and to define a structured arrangement as one where either:

- the hybrid mismatch is priced into the terms of the arrangement; or
- the arrangement has a purpose or effect of producing a hybrid mismatch.

12.8 As with the existing *Ben Nevis* factors which apply in the context of section BG 1, we propose that the list of factors provided in the Final Report be reproduced in guidance, rather than being legislated. This is also the approach recommended by the Australian Board of Taxation.

***KPMG comment:** A definition drafted per the second bullet point in 12.7 does not duplicate the facts and circumstances tests in 12.6. As Officials are aware, guidance is not binding on the Commissioner. It is therefore possible for an arrangement which is analysed as producing a hybrid mis-match to be characterised as a structured arrangement.*

The example we have used is of an investment in an Australian unit trust which is a FIF and to which the FDR method is applied. Using the analysis in paragraphs 5.48 to 5.51:

- *Distributions from the unit trust (which are dividends) are not taxable in New Zealand;*
- *Distributions from the unit trust are deductible to the unit trust (a dividend from a company in New Zealand terms). The unit trust does not pay tax on such distributions. It withholds tax payable by the investor.*

This is a hybrid mis-match: a D/NI result. It has that purpose or effect. Although there would not normally be any of the facts and circumstances described in 12.6, it would appear to be a structured arrangement.

Related persons

- 12.9 Recommendation 11.1(a) is that two persons are related if they are in the same “control group” (considered below) or:
- one of the persons has a 25 percent or greater interest in the second; or
 - a third person holds a 25 percent or greater interest in both.
- 12.10 For this purpose, a person who acts together with another person in respect of the ownership or control of any investment in another person will be treated as also owning that other person’s investment.
- 12.11 Two persons will be treated as acting together in respect of ownership or control of an investment if:
- they are family members. A person’s family members are:
 - persons who are within two degrees of relationship of the person, and those persons’ spouses;
 - the person’s spouse;
 - persons who are within two degrees of relationship of the first person’s spouse;
 - one regularly acts in accordance with the wishes of the other;
 - they have entered into an arrangement that has a material effect on the value or control of the investment; and
 - the ownership or control of the investment is managed by the same person or group of persons.
- 12.12 An investment in an entity can be a voting interest or an equity interest or both. A voting interest can apply to non-corporate as well as corporate entities, and is a right to participate in decision making concerning distributions, changes in the person’s constitution or the appointment of a director, broadly defined so that includes the persons who have management and control of an entity.
- 12.13 A look-through test applies to trace interests through interposed entities.
- 12.14 This approach is similar to that taken to determining whether or not two companies, two natural persons, and a company and a person other than a company, are associated under subpart YB 2 to YB 4 and YB 13 and YB 14, subject to the fact that for two companies, the test generally requires a 50 percent common ownership.⁶⁶ However, the application to trusts and partnerships seems somewhat different. While it would make sense to build so far as possible on existing definitions, it is likely to be preferable to do so by using a stand-alone definition which combines existing concepts plus the modifications necessary to ensure that New Zealand’s hybrid regime has the same scope as others enacted in accordance with Action 2.

⁶⁶ Also, the definition of a family member seems somewhat broader than the definition of a relative in section YA 1. For example, a person’s sister’s spouse is a family member but not a relative. We propose that the broader definition be used in this context.

KPMG Comment: It is not clear that the compliance difficulties that will arise from an extended definition of related persons and control groups have been adequately considered.

Control group

12.15 Two persons will be in a control group if:

- they are consolidated for accounting purposes, either under IFRS or applicable GAAP;
- one of them effectively controls the other, or a single person effectively controls both;
- one of them has a 50 percent or greater investment in the other, or a single person has a 50 percent or greater ownership of both; or
- they are associated enterprises under Article 9 of the OECD Model Treaty, which defines when transfer pricing adjustments may be made. The Final Report states that countries should apply their own transfer pricing thresholds for this purpose, so that if transactions between two entities are subject to transfer pricing adjustments under domestic law, they are in a control group for purposes of the hybrid rules (Final Report, paragraph 367).

12.16 In determining control and ownership, the same rules apply as those in determining ownership interests for purposes of the related person definition. In particular, interests of persons who act together in respect of their interests, or are treated as doing so, will be aggregated as set out in paragraph **Error! Reference source not found.** However, control is clearly a broader concept than ownership. For example, a substantial shareholder in a widely held company may have effective control over the appointment of directors, despite not having 50 percent of the rights to appoint the directors (Final Report, paragraph 364).

12.17 In the New Zealand context, in addition to the issues considered above in relation to the related person definition:

- consideration will need to be given to whether the existing reference to “control by any other means” in section YB 2(3) would be interpreted by New Zealand’s courts in a manner consistent with its interpretation in the Final Report. If not, a separate definition may be required;
- in accordance with the Final Report, two entities will be in a control group if they are associated persons for purposes of the transfer pricing provisions in subpart GC.

Payment

12.18 “Payment” includes non-monetary flows, such as a transfer of shares or any other asset. It includes not only things convertible into money, but also anything that would be paid for if provided at arm’s length. In New Zealand terms it would be covered by the definition of “money” which applies for purposes of the financial arrangement rules.

Submission point 12

Submissions are sought on any aspects of the OECD’s recommended definitions and how they could be adopted by New Zealand.

4 November 2016

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SUBMISSION: ADDRESSING HYBRID MISMATCH ARRANGEMENTS

Introduction

1. This letter contains Westpac's submissions on the Government discussion document *Addressing hybrid mismatch arrangements* released on 6 September 2016 ("**Discussion Document**").¹
2. In summary, our submissions are:
 - (a) regulatory capital instruments should be excluded from the scope of New Zealand's hybrid mismatch rules at least until it is clear to what extent other countries (and Australia in particular) will follow the United Kingdom's approach of excluding regulatory capital from the scope of such rules; and
 - (b) if regulatory capital instruments are not excluded from the rules, grandparenting in full should be available so that the rules do not apply to regulatory capital instruments issued prior to the release of the Discussion Document, or (in the alternative) at least to instruments issued prior to the release of the OECD Report.

First submission: regulatory capital instruments should be excluded from the hybrid mismatch rules

Discussion Document proposals

3. The Discussion Document states (at paragraph 5.60) that it is not proposed to exclude regulatory capital instruments from the implementation of hybrid mismatch rules in New Zealand. The Discussion Document calls for submissions as follows:

Submission point 5H

Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital.

¹ The Discussion Document proposes that New Zealand adopt the recommendations contained in the OECD report *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* ("**OECD Report**") released on 5 October 2015.

Regulatory capital instruments should be excluded from the hybrid mismatch rules

4. We submit that regulatory capital instruments should be excluded from the implementation of hybrid mismatch rules in New Zealand for these reasons:
- (a) The Discussion Document indicates (page 1) that "the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches". Regulatory capital instruments, on the other hand, meet regulatory requirements (administered, in the Australasian context, by the Reserve Bank of New Zealand ("**RBNZ**") and the Australian Prudential Regulation Authority ("**APRA**") for banks to maintain capital. The terms of such instruments are prescribed by the RBNZ and APRA. Regulatory capital instruments are therefore not tax driven transactions, do not amount to what the Discussion Document describes as "deliberate exploitation of hybrid mismatches", and are therefore outside the core concern identified in the Discussion Document.
 - (b) The OECD Report (at page 11) on which the Discussion Document is based leaves open the question of whether hybrid mismatch rules that countries may enact to implement the OECD Report recommendations should apply to regulatory capital instruments or should instead exclude such instruments from their scope. An OECD public discussion draft *BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* released in March 2014 ("**OECD Draft**") preceded the OECD Report. The OECD Draft indicated (at paragraph 158) that the separate consideration of regulatory capital was due to the "widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated". New Zealand would therefore be acting consistently with OECD recommendations were it to exclude regulatory capital instruments from its hybrid mismatch rules.
 - (c) The Discussion Document indicates (at page 1) that "[i]t is expected that most hybrid arrangements would be replaced by more straightforward (non-BEPS) cross-border financing instruments and arrangements following the implementation of the OECD recommendations in New Zealand". Given RBNZ and APRA requirements, regulatory capital instruments may not be simply replaced with more straightforward financial instruments.
 - (d) As the Discussion Document acknowledges (at paragraph 5.38) the OECD Report gives countries the option to exclude regulatory capital from their hybrid mismatch rules.² The rules implementing the OECD recommendations in the UK exclude regulatory capital. New Zealand should follow the UK's lead on this issue (especially while it is not certain what approach Australia will take).

Alternatively, regulatory capital instruments should be excluded from the hybrid mismatch rules pending clarification as to how other countries will proceed

5. Alternatively, if a permanent exclusion is not accepted, regulatory capital instruments should at least be excluded from the implementation of hybrid mismatch rules in New Zealand pending greater clarity as to how other countries (in particular Australia) will treat regulatory capital instruments under their hybrid mismatch rules. The effects of the

² The OECD Report states (at page 11) "[a]s indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital". The reference to "intra-group hybrid regulatory capital" appears to reflect the assumption in the OECD Draft (at paragraph 160) that regulatory capital issued to third party investors would be "unlikely to be caught" by hybrid mismatch rules.

hybrid mismatch proposals on the New Zealand economy cannot be known or predicted without first knowing what rules other countries will implement. For the banking industry, the position Australia will take is significant and is currently unknown.

6. For example, the OECD Report recommends that where a mismatch arises under a frankable-deductible instrument (see Example 2.1 of the OECD Report) the primary response is for the jurisdiction providing the dividend relief (in this case Australia) to disallow that relief. It seems highly likely that Australia will implement the OECD Report proposals to some extent.³ Accordingly, the circumstances in which a deduction may need to be denied under New Zealand's hybrid mismatch rules to counteract a hybrid mismatch under a frankable-deductible instrument would be if Australia:
 - (a) makes a policy choice to exclude certain frankable-deductible instruments from its hybrid mismatch rules; or
 - (b) has different implementation provisions from those applicable in the case of New Zealand's hybrid mismatch rules (eg, a different commencement date or approach to grandparenting).
7. In either circumstance, it would seem appropriate (when the OECD Report recommends that Australia provide the primary response to the arrangement) for New Zealand to consider Australia's position when formulating its own position. To avoid the risk of New Zealand adopting rules without regard to Australia's policy choices, regulatory capital instruments should be excluded from the hybrid mismatch rules at least until it is clear what approach Australia will take in respect of regulatory capital instruments.

Second submission: grandparenting should be available - proposals should not apply to existing regulatory capital instruments

Discussion Document proposals

8. The Discussion Document indicates that no grandparenting should apply if the hybrid mismatch rules are implemented in New Zealand. The Discussion Document also states (at paragraph 11.20):

The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311). Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be. ...

9. The Discussion Document calls for submissions as follows:

Submission points 11E

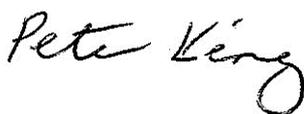
Submissions are sought on whether there are any special circumstances that would warrant departing from the general proposition of no grandparenting, and whether the proposed effective date is appropriate.

Regulatory capital instruments should be subject to grandparenting

10. If regulatory capital instruments are not excluded from the implementation of the hybrid mismatch rules, we submit that full grandparenting should be available for regulatory capital instruments issued prior to the release of the Discussion Document, or at least for instruments issued prior to the release of the OECD Report.

³ The Discussion Document (at paragraph 3.12) states that the Australian Government has committed to implementing OECD's recommendations.

11. Full grandparenting should be available for regulatory capital instruments for these reasons:
- (a) The main justification offered in the Discussion Document for no grandparenting (that the "rules generally apply to arrangements between related parties or within a control group [such that] restructuring arrangements should not be as difficult as it might otherwise be") is not applicable to many regulatory capital instruments because they are held by third party investors. Any redemption (even if permitted under an instrument's terms and approval is given by the relevant regulators, which cannot be guaranteed) would affect third parties, which typically include a large proportion of retail investors. In addition, the appetite for regulators to reduce the amount of regulatory capital on issue is low given global regulators are directing banks to increase capital levels.
 - (b) If regulatory capital instruments are not subject to grandparenting, existing instruments would likely need to be refinanced in the Australian or New Zealand domestic markets. Given that multiple banks would likely need to access these markets at the same time (if regulatory capital instruments are not subject to grandparenting), it would be difficult to refinance all of the affected instruments. This refinancing would be in addition to banks' existing Additional Tier 1 capital needs of approximately A\$4-\$6 billion per annum in aggregate. Given the limited capacity of the Australian and New Zealand domestic markets to absorb regulatory capital instruments in any year, multiple banks seeking to refinance regulatory capital instruments may cause market volatility and significantly increase the execution risk for such transactions, thereby undermining confidence in the markets. It is also possible that the Australian and New Zealand domestic markets would simply not be able to absorb all of the required regulatory capital issuances.
 - (c) The vast majority (if not all) regulatory capital instruments currently on issue were issued before the Discussion Document was released and, in most cases, prior to the release of the OECD Report. Further, prior to the OECD Report there was an expectation that any changes affecting hybrid arrangements would not apply to bank regulatory capital transactions, a position the OECD Report allows for and which the UK (one of the first jurisdictions to implement the OECD Report proposals) adopted.
12. For these reasons, if our first submission (that regulatory capital instruments should be excluded from the hybrid mismatch rules) is not accepted, our second submission should be accepted. That is, the hybrid mismatch rules should not apply to any regulatory capital instruments issued before the release of the Discussion Document, or (in the alternative) to instruments issued before the release of the OECD Report.



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10 November 2016

Addressing hybrid mismatch arrangements
C/- David Carrigan, Acting Deputy Commissioner
Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

ADDRESSING HYBRID MISMATCH ARRANGEMENTS

We are writing to submit on the discussion document "*Addressing hybrid mismatch arrangements*" (the "Discussion Document"). We are members of the Corporate Taxpayers Group (CTG), who is also making a submission on this topic; however, given the importance of this matter we are making a separate submission in respect of submission point 8 – foreign branches.

We have previously advocated for and continue to be supportive of an active income exemption for foreign branches. Extending the active income exemption for branches was on the Government's Tax Policy Work Programme from 2010-2015 and was first referred to in the December 2006 International Tax Review discussion document. Although we understand why this reform was deferred, we consider the deferral to be disappointing and are pleased it is again being considered.

Regardless of whether the proposals to adopt the deductible hybrid payment responses proceed, a foreign active branch exemption should be enacted. As we have noted previously (in submissions to Inland Revenue policy officials and the Minister of Revenue) we believe the treatment of branches should, where possible, mirror the treatment of CFCs. In our view, businesses that operate as subsidiaries or branches are no different from an operational view point and should be treated as such.

We understand the connection between the active income exemption for branches and BEPS, and that the introduction of such an exemption would restrict the flow through of foreign losses against the New Zealand tax base. We believe it is more appropriate that reforms should be shaped as an extension of the active income exemption for CFCs (which already contains robust base protection measures). This would result in a comprehensive international tax framework that is equally applicable to branches and subsidiaries and ensure tax consequences do not distort business structure decisions. We also consider this critical to reducing the current compliance costs that arise when operating offshore through a foreign branch.

The extension of the active income exemption to branches would materially assist in eliminating the potential for inappropriate outcomes without detailed hybrid rules applying to foreign branch structures. This should reduce compliance costs that will likely arise as a result of the implementation of the proposals.

We understand that there are currently concerns around the timing of when the hybrid mismatch proposals should be adopted and the consensus appears to be that New Zealand should align timing with other relevant jurisdictions. We understand that adoption in Australia is currently being delayed

until the treatment of regulatory capital is considered further and this may delay implementation in New Zealand. Implementation of the active foreign branch exemption in New Zealand in the meantime could demonstrate that policy officials are actively taking steps to address BEPS concerns. Australia has had an active foreign branch exemption for some time and therefore there is no reason to delay reform to New Zealand's foreign branch rules.

We set out below the background on our business and we reiterate and expand on the comments above.

Background

Fisher & Paykel Healthcare Corporation Limited (and its branches and subsidiaries) is a leading designer, manufacturer and marketer of products and systems for use in respiratory care, acute care and the treatment of obstructive sleep apnea.

Our headquarters, research and development facilities and New Zealand manufacturing operations are located in East Tamaki, Auckland, with products sold in over 120 countries worldwide. We currently have close to 30 offshore entities (subsidiaries and branches), nearly all of which sell and distribute our products. Principal sales and distribution sites are located in the United States, the United Kingdom, Europe, Asia and Australia.

Our competitors are predominantly headquartered in the United States or Europe with operations in multiple jurisdictions. We are therefore typically competing against companies which have enjoyed the benefits of an active income exemption for subsidiaries and branches or something similar for some time.

Comments

Extending the active income exemption to foreign branches **with minimal further delay** would, in our view:

- help ensure that the momentum generated from the CFC/FIF reforms is not lost;
- materially reduce the compliance costs that New Zealand based multi-nationals incur in relation to foreign branch activities;
- improve New Zealand's international competitiveness with our major trading partners and competitors, including Australia;
- with respect to our business, represent New Zealand taking another step forward in levelling the playing field between ourselves and our foreign headquartered competitors.
- would demonstrate that policy officials are actively taking steps to address BEPS concerns.

As noted previously, we believe the treatment of branches should, where possible, mirror the treatment of CFCs. The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project *Designing Effective Controlled Foreign Company Rules* ACTION 3: 2015 Final Report contemplates the application of CFC rules focussing on the attribution of income that gives rise to BEPS concerns (i.e. passive income) to foreign branches. The application of an active income exemption to branches is consistent with the recommendations in the report. We support the view that the relevant focus area is on the type of income rather than the type of entity and believe the most coherent legislative solution is to extend the current CFC treatment.

The introduction of the proposals contained in the Discussion Document would restrict the flow through of foreign losses against the New Zealand tax base and there are concerns about the impact on taxpayers of removing this flow through of losses from foreign branches (especially for small start-up type businesses). While this is generally only a timing benefit as future income arising from the foreign branch should also be recognised in New Zealand, it is possible for taxpayers to structure their arrangements such that this is not necessarily the case. Therefore, in some situations tax consequences are currently distorting business structure choices.

The potential issues with use of foreign branch losses against New Zealand income are detailed in the Discussion Document. The general principle is that foreign branch losses should only be able to be used against foreign branch income which is also taxable in New Zealand (referred to as "dual inclusion income") unless there is no ability to otherwise utilise the losses in the foreign jurisdiction. The

extension of the active income exemption to branches would materially assist in eliminating the potential for inappropriate outcomes without the need for the application of detailed hybrid rules.

If the proposals in the Discussion Document do not proceed we consider the active branch exemption should still be enacted. If there is concern about denying the flow through of losses from foreign branches (especially for small start-up type businesses), we suggest introducing an elective regime under which taxpayers could choose to make an irrevocable election into an active exemption regime for foreign branches. This would provide the necessary compliance relief and alignment with CFC/FIF treatment for taxpayers that make the election, but would retain the status quo for those that do not make the election. We see merit in an elective regime with appropriate base maintenance protection measures to prevent the potential opportunities that exist for inappropriate outcomes even within the current regime.

Finally, we note that we are a New Zealand business employing a large and growing number of New Zealanders. We want to continue to be based in New Zealand and pay the majority of our tax here. We encourage officials to ensure we and other New Zealand headquartered businesses have access to international tax legislation we deserve to assist (or at the least not inhibit) this intention and our competitive position.

We appreciate the opportunity to provide a submission on the paper and we would be happy to be contacted to discuss any points raised in this submission. In the first instance, please contact Rachael Bull.

Yours faithfully



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Chief Financial Officer

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Response to

Inland Revenue

on the

Addressing Hybrid mismatch arrangements

11 November 2016

Strictly Confidential

1.0 INTRODUCTION

- 1.1 This submission has been prepared by Bank of New Zealand ('BNZ') in response to Inland Revenue's ('IR') discussion document, 'Addressing hybrid mismatch arrangements' released in September 2016 (the 'Discussion Document').
- 1.2 BNZ welcomes this opportunity to provide a response to the Discussion Document and while we are grateful for the additional time allowed for submissions, we note that the relatively short timeframe in which the proposals are intended to be advanced is challenging. The proposals are complex and significant time is required to properly understand the potential impacts the proposals may have. Given the complexity and the risk of unintended consequences in implementation, an extended timeframe for advancing these proposals should be considered.
- 1.3 BNZ is a member of the Corporate Taxpayers Group ('CTG') and has been involved in the submission the CTG has made on the Discussion Document. While BNZ is in total alignment with the submissions made by the CTG, BNZ wishes to make an additional specific submission on certain aspects of the proposals. We outline those submission points below.

2.0 EXECUTIVE SUMMARY

- 2.1 BNZ submits that there are good reasons to adopt many of the OECD recommendations provided those recommendations are in the best interests of New Zealand and are appropriate in the New Zealand context. BNZ questions the need for wholesale adoption of the OECD recommendations, particularly as several of the concerns the OECD recommendations aim to counter do appear to be adequately addressed through existing New Zealand tax rules. BNZ would prefer to see targeted measures directed at real as opposed to theoretical risks to the New Zealand tax base.
- 2.2 Any of the OECD recommendations that are implemented in New Zealand need to be in harmony with other proposed and pending New Zealand tax law changes, and the OECD recommendations should not be considered and evaluated in isolation. BNZ hopes to see, as part of the consultation process, further consideration of how the OECD recommendations align with, for example, recently enacted changes to non-resident withholding tax, Approved Issuer Levy and branch structure rules.
- 2.3 Importantly, BNZ submits that banking regulatory capital should be excluded from the hybrid financial instrument rule. Hybrid instruments are commonly used by New Zealand registered banks for regulatory capital purposes and the hybrid nature of these instruments is a consequence of the strict capital adequacy rules imposed by the Reserve Bank of New Zealand. In the regulatory capital context, hybrid instruments are not entered into with a tax planning purpose and absent the regulatory capital requirements, BNZ would prefer to use ordinary debt funding without hybrid features.
- 2.4 If the Government decides not to exclude regulatory capital, then BNZ submits that the scope of application and timing of introduction of the proposals to regulatory capital should be in line with any introduction of the equivalent rules in Australia.
- 2.5 If the Government decides not to exclude regulatory capital, BNZ submits that grandfathering of regulatory capital should be available for regulatory capital where the hybrid instruments were issued before the date legislation to enact the OECD recommendations is introduced. The grandfathering period should last for the term of the financial instrument.
- 2.6 BNZ submits that where a deduction/non-inclusion outcome is only temporary, the approach recommended by the Australian Board of Taxation should also be applied in New Zealand.
- 2.7 BNZ submits that any denied deductions in New Zealand should be able to be carried forward and used in future periods if the income is effectively taxed in the other jurisdiction. This is particularly

important in the trans-Tasman context where both Australia and New Zealand operate imputation regimes. Absent the ability to carry forward deductions the proposals will result in double taxation when company tax and shareholder tax are considered in totality.

3.0 SUBMISSIONS

High-level comments

- 3.1 BNZ is supportive of the overall intent of the proposals to neutralise the effect of hybrid mismatch arrangements as a means of countering abusive cross border tax structures. However, any changes in New Zealand tax legislation must be appropriate to the New Zealand tax context and must be evaluated in conjunction with other pending legislative changes and the particular features of New Zealand's tax system. Changes as fundamental as those proposed in the Discussion Document should not be considered in isolation.
- 3.2 BNZ does not support wholesale adoption of the OECD recommendations. The recommendations should only be adopted to the extent they address a real (as opposed to theoretical) risk or are demonstrably in the best interests of New Zealand.
- 3.3 BNZ notes that, while stating our general support for the direction and intent of the proposals, BNZ considers that the Discussion Document likely overstates the potential benefit to New Zealand as it is likely that hybrid financial instruments would be replaced with deductible debt. In most cases the level of debt and the amount of interest deduction would not be materially affected if hybrid instruments issued by New Zealand multinationals were replaced with vanilla debt. The Optional Convertible Note (OCN) cases cited at 3.17 are a case in point where if, instead of an OCN, simple debt funding was provided to the New Zealand subsidiary, the level of deductible interest expense would be broadly the same as the deductions claimed the OCN. Any revenue gain to New Zealand would be minimal despite a significant increase in compliance costs along with a likely increase in the cost of capital in New Zealand if regulatory capital is not excluded.
- 3.4 While BNZ understands Government's desire to align as much as possible with other OECD members, it still needs to balance the overall costs the proposals will impose on New Zealand taxpayers with the expected net benefit to New Zealand. The proposals should not be adopted wholesale without a more detailed consideration of whether it is in fact in the best interests of New Zealand to do so. In respect of the proposal not to exempt regulatory capital, BNZ considers that the additional cost of capital in New Zealand does not appear to be justified by the tax risks the proposals seek to address.

Timing mismatches - Submission points 5C

- 3.5 BNZ supports an approach such as that recommended by the Australia Board of Taxation to exclude temporary mismatches from the proposed rules.

Regulatory capital - submission point 5H

- 3.6 BNZ submits that banking regulatory capital should be excluded from the application of the hybrid mismatch rules.
- 3.7 The OECD report explicitly gives countries a choice as to whether to exclude regulatory capital, and the United Kingdom, the first country to adopt the OECD recommendations, has chosen to exclude regulatory capital. It is not yet clear how other countries will treat regulatory capital and it is not in New Zealand's interests to be the only country to apply the OECD recommendations to regulatory capital. At the very least, New Zealand should defer a decision on the application of regulatory capital until it is more clear how other jurisdictions intend to progress.

- 3.8 The use of hybrid instruments for regulatory capital purposes can and should be distinguished from the hybrid financial instruments that are the target of the hybrid financial instrument rule. Importantly, New Zealand banks do not use hybrid financial instruments with a purpose or intent of achieving a tax mismatch, rather, the use of such instruments is a direct consequence of the regulatory capital rules requiring that funding instruments for New Zealand banks have equity like features and loss absorbing qualities.
- 3.9 The OECD report states at paragraph 278 that its recommendations are not intended to identify lost tax revenues but are to discourage the use of hybrid instruments and hybrid entities. This purpose is appropriate, however it is clearly at odds with the New Zealand regulatory capital rules that effectively require hybrid instruments to be used.
- 3.10 The IR Discussion Document does not provide any reasoning for IR's preference to not exclude regulatory capital. In contrast, BNZ considers that there are good reasons for regulatory capital to be excluded.
- 3.11 Hybrid financial instruments that are used for regulatory capital purposes are used in order to provide funding to New Zealand banks that meet stringent regulatory capital requirements and at the same time provide a competitive cost of funds to New Zealand banks. In absence of the regulatory capital restrictions, BNZ's preference would be to obtain funding through vanilla debt as it is simpler and cheaper to implement than a hybrid instrument.
- 3.12 If regulatory capital becomes subject to the proposals, the denial of a deduction in New Zealand becomes an increase in the net cost of funds to the New Zealand bank. This will inevitably (directly or indirectly) lead to an increased cost of capital to New Zealand businesses and is counter to the Government's Business Growth Agenda.
- 3.13 New Zealand's existing tax rules include specific banking thin capitalisation provisions which define the level of debt and therefore the relative interest deductions Parliament has contemplated and deemed appropriate. BNZ, operates well within these prescribed limits and will continue to do so. Absent the regulatory capital rules New Zealand banks operate under, the funding would not take the form of a hybrid instrument and would be ordinary debt where the interest deductions would not be subject to the proposed hybrid financial instrument rule. There is no suggestion in the discussion document that New Zealand's banking thin capitalisation rules are not operating effectively.

Transitional rules

- 3.14 If Government decides not to exclude regulatory capital from the scope of the proposals, BNZ submits that hybrid financial instruments that qualify as regulatory capital should be grandfathered. The grandfathering should apply to all qualifying hybrid instruments that have been issued prior to the date the new legislation is introduced into parliament and should continue to be grandfathered until the instruments mature, are converted or are repaid.
- 3.15 The Discussion Document assumes that winding up regulatory capital can be done quickly and easily. This is not the case. Reserve Bank approval is likely to be required and suitable alternative regulatory capital must be found. In addition, in some circumstances external investors may be impacted and securities and financial markets legislation may need to be complied with. For these reasons, BNZ submits that qualifying regulatory capital should be eligible for grandfathering for the life of the instrument.
- 3.16 Also, BNZ does not consider that New Zealand banks have had sufficient time to consider the impact of the proposals on the basis that the OECD recommendations were published in the OECD's final report in October 2015. The OECD report explicitly gives a choice to each country as to whether to include regulatory capital in the scope of the proposals. As mentioned earlier in this

submission, some jurisdictions have chosen to carve out regulatory capital, while others, most notably Australia, are considering their position. Therefore, until the release of the IR Discussion Document in September 2016 it was not clear what New Zealand's position on this would be.

- 3.17 Regulatory capital issuances are months in the planning and the structure, terms and pricing of the instruments cannot be easily and quickly altered. Further, until legislation is introduced, New Zealand banks cannot be certain of the extent their various funding structures are impacted and for that reason, grandfathering should be available for all regulatory capital hybrid instruments that have been issued before the date new legislation is introduced into parliament.

Hybrid transfers - Submission point 5I

- 3.18 BNZ submits that New Zealand should include an exemption for hybrid transfers where a trader of a financial instrument is a party. Repo and security lending arrangements are commonly used by banks and their corporate customers to facilitate short term funding. Such transactions are not entered into with a purpose of achieving a tax mismatch and given the typically short term nature of these transactions the risk to New Zealand is likely to be insignificant and would not justify the complexity involved in bringing these transactions within the scope of the proposals.

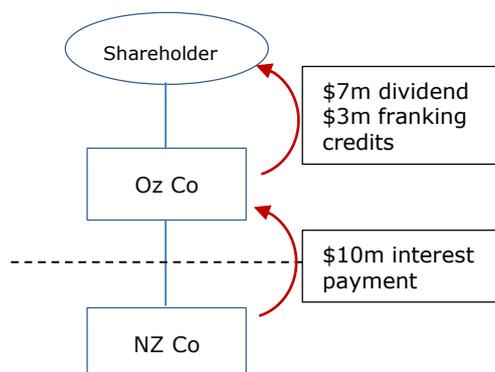
Interaction with withholding taxes - Submission point 11A

- 3.19 BNZ submits that the New Zealand withholding taxes outcomes should be amended to ensure they reflect the in-substance tax outcome effected by the OECD recommendations. For example, application of the primary rule in the New Zealand setting is equivalent to a re-characterisation of a debt instrument as equity (i.e. treating a deductible coupon payment as a non-deductible dividend payment). BNZ submits that the withholding tax impost should reflect this re-characterisation and withholding tax should be levied as if the payment were a dividend payment.
- 3.20 Alternatively, if withholding tax continues to apply to interest payments on hybrid financial instruments, a deduction should be allowed in New Zealand to the extent that withholding tax has been paid. The rationale for the anti-hybrid rules is explicitly to prevent double non-taxation. Where New Zealand withholding tax has been imposed there is clearly a level of tax imposed on the recipient of the payment, albeit in New Zealand rather than the foreign jurisdiction. It seems a logical conclusion that if tax has been suffered by the recipient of a payment of income, there is no need to deny a deduction to the payer as there is no double non-taxation to counteract.

The Trans-Tasman context

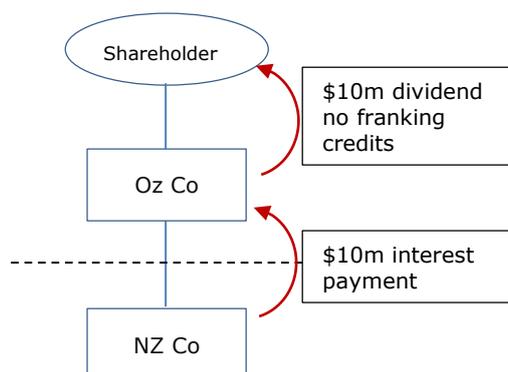
- 3.21 It is well understood that a significant proportion of foreign direct investment into New Zealand is from Australia. The tax settings present in this wider context should not be ignored when considering whether there is a compelling case for wholesale adoption of the OECD recommendations.
- 3.22 Specifically, New Zealand and Australia are unique internationally in that both countries continue to have imputation regimes. The nature of an imputation regime is that corporate tax effectively becomes an interim tax on the shareholders, meaning that even if a deductible/non-inclusion outcome appears to arise at the corporate level, the operation of the imputation regime means that the income is taxed on distribution to shareholders. The OECD gives little consideration to this in its final report.
- 3.23 As an example, consider a New Zealand subsidiary of an Australian company with Australian resident shareholders. The Australian parent provides funding to its New Zealand subsidiary. Assume the New Zealand entity incurs an interest cost of \$10m, which in scenario 1 below is incurred on an intercompany loan and in scenario 2 is interest incurred on a hybrid instrument where the coupon payments under the hybrid are not taxed in Australia.

3.24 Scenario 1 - intercompany loan



3.25 NZ Co claims a deduction in New Zealand for the interest cost while Oz Co has \$10m of taxable income and so pays \$3m of Australian income tax. When the profit derived by Oz Co is paid to its shareholder by way of dividends, franking credits are attached. Assuming the shareholder is subject to a 37% marginal tax rate in Australia, the shareholder has a tax liability of \$3.7m which is partially satisfied by franking credits of \$3m. A further \$0.7m of tax is paid by the shareholders resulting in total tax paid in Australia of \$3.7m.

3.26 Scenario 2 - hybrid instrument (deductible interest in New Zealand; non-taxable dividend in Australia)



3.27 NZ Co claims a deduction in New Zealand for the interest paid under the hybrid instrument. However, the coupon is treated as a dividend in Australia and is exempt from income tax on receipt by Oz Co. Therefore, Oz Co has nil taxable income but an accounting profit of \$10m. It is this asymmetric tax outcome that is considered to be tax base erosion and which is the target of the proposed hybrid financial instrument rule.

3.28 However, when the profit derived by Oz Co is paid by way of dividend to its shareholder, the dividend is unfranked. Assuming (as above) the shareholder is subject to a 37% marginal tax rate in Australia, shareholder has tax to pay of \$3.7m with no franking credits to offset the liability. The total tax paid in this scenario is \$3.7m, which is identical to scenario 1, meaning that there has been no net erosion of tax revenues collected.

3.29 The recommendations put forward by the OECD are more easily justified when hybrid financial instruments are used between jurisdictions that operate a classical dual tax system. Less so, when imputation applies.

3.30 One response to this argument is that Oz Co can choose to not fully distribute its profits meaning that there potentially a permanent deferral of the tax impost at shareholder level. However, the converse also applies, in that to the extent a company does fully distribute its retained profits, the application of the hybrid financial instrument rule would result in double taxation – once in New Zealand by way of the denial of the tax deduction on the interest payment and again in Australia at the ultimate shareholder level. This impact on trans-Tasman investment should not be overlooked in considering the appropriateness of the OECD proposals to the New Zealand context.

4.0 CONCLUSION

4.1 BNZ is pleased to provide this submission and the information it contains. BNZ is available to discuss any issues raised.

4.2 Should IR have any questions in relation to this submission, please contact:

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Head of Tax, BNZ

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Mobile: [REDACTED]
Email: campbell_rapley@bnz.co.nz

11 November 2016

Addressing hybrid mismatch arrangements
C/- David Carrigan, Acting Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

Addressing hybrid mismatch arrangements – Government discussion document

We are writing in respect of the Government discussion document, *Addressing hybrid mismatch arrangements* (herein referred to as "the Paper"). We appreciate the opportunity to comment on the Paper.

Executive summary

From a policy perspective, our primary submission points are the following.

- A de minimis rule should be included to ensure that the proposals (and the resulting compliance costs) are correctly targeted.
- We are not supportive of the proposals to deny a deduction for a New Zealand business' foreign branch losses. This proposal would likely discourage the use of a common structure utilised by New Zealand businesses when expanding overseas.
- The denial of an immediate deduction for a New Zealand business' foreign branch losses would be untenable without an active income exemption.

In addition to the above, we also have the following general submission points.

- The Paper is long, complicated and technical in nature.
- The Paper should include an executive summary to assist readers in understanding the proposals.
- We endorse submissions made by the Corporate Taxpayer Group and support the detail included in their submission, particularly comments in relation to the proposal's application date and grandparenting.
- The consultation period for the Paper overlapped with a number of other outputs from Inland Revenue which required more immediate analysis.
- Further consultation should take place with respect to refining the proposals (including draft legislation).
- Separate consultation should take place in relation to the inclusion of a de minimis rule and an active income exemption (if Officials agree with our submissions).

Given the complexity of the Paper we have only provided high level submission points and have not submitted on the detail.

General comments

The Paper is an 83 page document discussing New Zealand's implementation of the OECD's recommendations included in their 454 page paper entitled *Neutralising the Effects of Hybrids Mismatch Arrangements*. The Paper is long, complicated and technical in nature. The Paper does not include an executive summary to assist readers in understanding proposals recommended by Officials. A summarised table of the proposals and common examples of where they could impact would be useful.

De minimis rule

The complexities of the proposals are likely to add significant compliance costs for affected taxpayers. Compliance costs will be incurred up-front in understanding the proposals and how they affect the taxpayer's business, and then on an on-going basis in ensuring continued compliance. Given their complexity, if the proposals are to proceed, we do not agree that all taxpayers should be subject to the proposals.

To ensure the proposals and the resulting compliance costs are correctly targeted, we submit that Officials should consider a de minimis rule. We recommend a rule to carve-out smaller sized taxpayers or small transactions that do not pose a material risk to New Zealand's tax base. We recommend that the de minimis rule is based on the taxpayer's overall turnover for smaller taxpayers (e.g. under \$80 million) and based on transaction value for larger taxpayers (e.g. under \$1 million of relevant income or expenditure).

Deductible hybrid payments

Foreign branches of New Zealand businesses

Chapter 8 (Deductible hybrid payments) proposes to deny a deduction for a New Zealand business' foreign branch losses (except against dual inclusion income from the same country). This proposal may detrimentally affect New Zealand businesses with foreign branches given the compliance costs that they will face, the change in the ability to use foreign losses against New Zealand income and the risk that certain losses will never be able to be used. We consider that this proposal, in the absence of an active income exemption, would not serve New Zealand's best interest. The use of foreign branches by a New Zealand business is common practice in the initial stage of operating in another country, particularly for SMEs who have a greater tendency to expand to another country via a branch structure due to lower compliance costs. The use of the foreign branches by a New Zealand business would therefore be discouraged by this proposal. This would be detrimental to New Zealand as, with the New Zealand market being so small, businesses must be able to easily expand offshore to grow the New Zealand economy.

Accordingly, we are not supportive of the proposals to deny a deduction for a New Zealand business' foreign branch losses.

Active income exemption

On page 65 of the Paper, Officials specifically call for submissions on whether the denial of a deduction for foreign branches losses against New Zealand income should be matched by an exemption for active income earned through foreign branches. We are strongly supportive of an exemption for active income earned through a foreign branch, especially if the

proposals in relation to foreign branches proceeds and our de minimis rule submission is not accepted by Officials.

We consider that an exemption for active income earned through a foreign branch would alleviate some of the issues caused by the deductible hybrid payment proposals. Despite this, we note that the proposals would still increase the overall compliance costs faced by New Zealand businesses using the foreign branch structure.

Based on this, it is our view that the denial of an immediate deduction for a New Zealand business' foreign branch losses would be untenable without an active income exemption.

Corporate Taxpayer Group

During the process of reviewing the Paper, we have liaised with the Corporate Taxpayer Group ("the Group"). While submission points included in our submission are limited, we endorse submissions made by the Group and support the detail included in their submission.

In particular, we are supportive of the following submissions made by the Group.

- A grandparenting period of three years following the date of enactment would be appropriate for existing arrangements, to enable a transition to the new rules.
- New Zealand should at a minimum have a similar implementation date for the hybrid rules to Australia and, if there is a delay in their hybrid rules being enacted, New Zealand could consider delaying the implementation date until similar proposals are in force in Australia.

Other comments

Deadline extension

We are appreciative that Officials have considered it appropriate to extend the Paper's submission deadline, however we note that the consultation period for the Paper overlapped with a number of other outputs from Inland Revenue which required more immediate analysis.

For example, the Supreme Court's judgement in *Trustpower v Commissioner of Inland Revenue* was released on 27 July 2016 and the updated draft interpretation statement on the deductibility of feasibility expenditure was released on 14 October 2016. The Commissioner's case impact statement on the Supreme Court case provides that tax positions taken after the date of the judgement should take into account the *Trustpower* decision. As a result, the analysis of feasibility expenditure for income tax returns currently being prepared has been prioritised by many taxpayers over hybrid mismatch arrangements proposals which are not expected to affect income tax returns currently being filed (i.e. hybrid mismatch arrangements are expected to apply to payments made after the taxpayer's first tax balance date following enactment).

Further consultation

The Paper is inherently complex, which means not all scenarios can be modelled for. We consider that further work is required to determine the impact of proposals on all likely scenarios. We therefore submit that further consultation should take place with respect to refining the proposals (including draft legislation).

Additionally, if Officials agree with our submissions points, we submit that separate consultation should take place in relation to the inclusion of a de minimis rule and active income exemption.

For any queries in relation to this submission, please don't hesitate in contacting Robyn Walker (04 4703615 or robwalker@deloitte.co.nz) or Brad Bowman (09 303 0885 or bbowman@deloitte.co.nz).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Robyn Walker', is positioned above the printed name and title.

Robyn Walker
National Technical Director
for Deloitte Limited (as trustee of the Deloitte Trading Trust)



11 November 2016

Addressing hybrid mismatch arrangements
C/- David Carrigan, Acting Deputy Commissioner
Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

ADDRESSING HYBRID MISMATCH ARRANGEMENTS

The Corporate Taxpayers Group (the "Group") is writing to submit on the discussion document "*Addressing hybrid mismatch arrangements*" (the "Discussion Document").

The Group is appreciative of the opportunity to submit on this Discussion Document and the time spent by Officials to date in discussing these proposals with us.

Summary of our submission

The key points in our submission are:

General comments

- New Zealand should not proceed with the wholesale adoption of the OECD recommendations in relation to Hybrids, as:
 - the solutions proposed by the OECD are complex;
 - the number of instances of improper use of hybrid arrangements appears to be limited;
 - the proposed solution will often require taxpayers to seek foreign tax advice when applying the rules;
 - there is significant resource cost and opportunity cost involved in advancing these proposals.

The better approach would be for New Zealand to consider targeted reform with rules addressing particular areas of concern.

- If it is not possible to apply a more targeted approach, the focus should be on making these rules as simple as possible and remove any unintended consequences. Further, if the rationale for a comprehensive solution is based on alignment with the OECD, then

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as a minimum we need to ensure that New Zealand aligns to the timing of adoption of other relevant jurisdictions, their transition periods and any grandfathering provisions.

- There are a number of ambiguities / unanswered questions with these proposals that are detailed in Appendix Two of this submission. Before proceeding further with these proposals, we suggest that these questions are considered further. We would like to arrange a meeting with Officials to discuss these further.

Economic analysis

- Some of the economic claims made in Chapter 3 of the discussion document appear questionable and we would be interested in seeing what economic analysis has taken place in relation to these claims. We would be interested in receiving clarification from Officials on this.

De-minimis threshold

- Given the complexity of the proposals, we believe it would be appropriate that a de-minimis threshold is introduced where transactions below a certain threshold are not subject to the hybrid rules. This will ensure that the rules are more appropriately targeted at transactions where the tax revenue at stake justifies the compliance costs imposed on the business.

Further consultation and timeframe

- This discussion document contains significant and complex tax proposals that require a lot of time to consider adequately. The timeframe for making submissions on the discussion document has not allowed sufficient time for the tax community to fully consider the wide-ranging impacts of the proposals.
- The current timeframe for advancing these proposals should be extended to enable sufficient time to properly consider and address the issues, compare New Zealand's position with other countries and reduce the risk of unintended consequences.
- In addition, as submitted below, these proposals warrant the introduction of an active income exemption for branches, which requires an additional consultation process.
- While the discussion document attempts to articulate proposals, it is only once proposals are put into draft legislation that taxpayers can really begin to analyse and appreciate how the proposals may impact on their business arrangements. Therefore we strongly recommend that an exposure draft with draft legislation should be released for further consultation prior to including these proposals in a Tax Bill.

General rule for introduction

- We do not agree with the proposed application date for these proposals. It is important that New Zealand's implementation date is not in advance of other OECD member nations, particularly Australia's.
- New Zealand should not be an early adopter of these proposals because if we do act early, we risk a material increase in compliance costs as taxpayers will need to analyse their arrangements and the current foreign tax treatment, monitor legislative changes in foreign jurisdictions, and adopt different treatments in New Zealand as changes progress overseas.



- We submit that New Zealand should at a minimum have a similar implementation date for the hybrid rules to Australia and if there is a delay in their hybrid rules being enacted, New Zealand should consider delaying the implementation date until similar proposals are in force in Australia.

Grandparenting and transitional period

- In the Group's view, a grandparenting period of three years following date of enactment would be appropriate for existing arrangements, to enable a transition to the new rules.
- Even if Officials do not accept a grandparenting period for all existing arrangements, there is a good case for grandparenting in specific circumstances. Given our close ties to Australia, if Australia includes some form of grandparenting treatment for regulatory capital, in the Group's view it would be necessary for New Zealand to apply similar treatment.

Timing differences

- We agree with Officials that the Australian Board of Taxation approach would be preferable for New Zealand. This approach has advantages over the OECD approach as it is more certain by providing objective criteria for determining when there is a timing mismatch. In addition, it is a more reasonable approach as it allows denied deductions to be carried forward.
- The discussion document does not consider how the rules may apply in situations where NZ recognises the treatment of interest and foreign exchange as a single item of Financial Arrangement income under our Financial Arrangement rules, as compared to other countries that might treat these amounts separately. We submit that further consideration needs to be given to this issue, and Officials need to provide further guidance on this in any further consultation on these proposals.

Taxation of FIF interests

- Our primary submission is that FDR, cost and DRR methods should not be altered in response to the hybrid proposals. This goes beyond the scope of the core policy concern and should not be an area of focus.
- If the proposals in this area, do proceed we suggest that the preferred approach should be to deny the ability to use the FDR, cost and DRR methods for shares on which any dividend would be deductible to the payer and simply tax the dividend. This appears to be the least complex and most straightforward to apply. However, we have not considered these options in detail.

Regulatory capital

- At a minimum, given our close ties to Australia, if Australia either excludes regulatory capital or regulatory capital is subject to grandfathering treatment, New Zealand should follow a similar approach.
- Even if Australia does not adopt grandfathering treatment for regulatory capital, there are good reasons for adopting grandfathering treatment to provide financial institutions with a transitional period to adapt to the new rules.
- There should be a grandparenting period of 5 years from the effective date (assuming the proposals are enacted in 2018). In addition, grandparenting treatment should



apply to all regulatory capital issued prior to the release of this discussion document as prior to this date, there was no certainty on the position that Officials would take in respect of regulatory capital.

Carry-forward of denied deductions

- We do not support the existing loss carry forward rules being used as a basis for allowing the carry forward of disallowed deductions under the hybrid rules. This is because the policy behind the existing loss carry forward rules is different to those applying to the hybrid rules. In addition, the Group has concerns around the continued appropriateness of the existing loss carry-forward continuity threshold.
- To prevent double taxation, if excess dual inclusion income is returned in a subsequent year, and deductions have been denied in a prior period, it is appropriate that this be offset to prevent double taxation, regardless of changes in ownership in excess of 51% during the total period.

Dual inclusion income

- As dual inclusion income is a fundamental concept to these proposals, we believe that further consideration needs to be given to what is and what is not dual inclusion income. Officials need to provide further guidance on this concept in any further consultation on these proposals.
- We do not agree with the proposal to depart from the OECD's recommendations in relation to CFC income as dual inclusion income.

Carry forward / reversal of defensive rule income

- We agree that there should be some carry forward of defensive rule income. A "reversal" rule for the application of the defensive rule is the most straightforward and least complex approach. Despite this, we submit that the best way forward would be to allow taxpayers a choice of options.

Reverse Hybrids

- In relation to Recommendation 4, the Group strongly submits that CFC income should be respected as income of the payee to ensure there is no denial of a deduction where the income is recognised in the parent of the reverse hybrid as CFC income.
- We do not consider that the suggested changes to the CFC regime in paragraph 7.19 (Recommendation 5.1) in the Discussion Document are required given the breadth of New Zealand's CFC regime and the complexity this will give rise to.

Deductible hybrid payments – Application to branches

- If the proposal to deny a deduction for foreign branch losses, do proceed it is critical that this is balanced by an active income exemption for foreign branch income.
- Further, aspects of these rules will be need to be clarified. In particular, clarification of when a loss offset by a foreign branch is "not possible" to enable losses to be offset against the income of a NZ entity.

Further detail on these submission points are included at Appendix One to this submission. A list of questions regarding the Discussion Document proposals are included at Appendix



Two. As noted above, we would like to arrange a meeting with Officials to discuss these questions.

Please contact us if you wish to discuss any of the matters raised in our submission further with us.

For your information, the members of the Corporate Taxpayers Group are:

- | | |
|---|---|
| 1. Air New Zealand Limited | 20. Methanex New Zealand Limited |
| 2. Airways Corporation of New Zealand | 21. New Zealand Post Limited |
| 3. AMP Life Limited | 22. New Zealand Racing Board |
| 4. ANZ Bank New Zealand | 23. New Zealand Steel Limited |
| 5. ASB Bank Limited | 24. New Zealand Superannuation Fund |
| 6. Auckland International Airport Limited | 25. Opus International Consultants Limited |
| 7. Bank of New Zealand | 26. Origin Energy New Zealand Limited |
| 8. Chorus Limited | 27. Pacific Aluminium (New Zealand) Limited |
| 9. Contact Energy Limited | 28. Powerco Limited |
| 10. Downer New Zealand Limited | 29. Shell New Zealand (2011) Limited |
| 11. Fisher & Paykel Healthcare Limited | 30. SKYCITY Entertainment Group Limited |
| 12. Fletcher Building Limited | 31. Sky Network Television Limited |
| 13. Fonterra Cooperative Group Limited | 32. Spark New Zealand Limited |
| 14. General Electric | 33. T & G Global Limited |
| 15. Genesis Energy Limited | 34. The Todd Corporation Limited |
| 16. IAG New Zealand Limited | 35. Vodafone New Zealand Limited |
| 17. Infratil Limited | 36. Westpac New Zealand Limited |
| 18. Lion Pty Limited | 37. Z Energy Limited |
| 19. Meridian Energy | 38. ZESPRI International Limited |

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Yours sincerely

John Payne
For the Corporate Taxpayers Group



APPENDIX ONE: DETAILED SUBMISSION POINTS

1. General comments

Scope of proposals

- 1.1 The Group agrees that some changes to the rules may be necessary, as the world in which businesses operate has evolved – and so must New Zealand’s tax settings. However, we question whether the proposed solution to the issue of hybrid mismatch arrangements is proportionate with the problem. We understand why it may be difficult to estimate the impact hybrid arrangements are having on the New Zealand tax base, but in absence of such evidence, there is no justification for the complexity that these proposals would introduce.
- 1.2 Paragraph 3.26 of the Discussion Document notes that “*any new rules addressing hybrid mismatch arrangements should be effective from a policy perspective, but be as simple as possible to comply with and administer*”. By their very nature, given these proposals are so complex (even for experienced tax professionals) and require taxpayers to consider the tax treatment in another jurisdiction in order to determine the New Zealand tax treatment, this will be very difficult to achieve. This complexity is likely to give rise to unintended or adverse outcomes that are not subject to the same policy concerns as hybrid mismatch arrangements.
- 1.3 There is a good case for New Zealand not to proceed with the wholesale adoption of the OECD recommendations in this area, given that:
 - the solutions proposed by the OECD are complex;
 - the number of instances of improper use of hybrid arrangements appears to be limited;
 - the proposed solution will often require taxpayers to seek foreign tax advice when applying the rules
 - There is significant resource and opportunity costs involved in advancing these proposals.

The Group is not advocating for double non-taxation. However, in the Group’s view, a better approach would be for New Zealand to consider targeted reform with rules addressing particular areas of concern. Officials should identify particular arrangements or structures they find offensive from a New Zealand revenue protection and welfare maximising point of view (as they have done in the discussion document, for example Australian limited partnerships) and design rules to combat those, using the OECD recommendations as a framework.

- 1.4 If it is not possible to apply a more targeted approach, the focus should be on making these rules as simple as possible and remove any unintended consequences. This is the focus of our submission points on the detailed proposals.
- 1.5 We consider that there are a number of unanswered questions with these proposals which are detailed in Appendix Two of this submission. These arise from the complexity of the discussion document proposals. Before proceeding further with these proposals, we suggest that these questions will need to be considered further before proceeding to the draft legislation stage. We would welcome a meeting with Officials to discuss these further.



Consideration of foreign tax rules

- 1.6 It is clear that taxpayers will need to seek foreign tax advice when applying the hybrid rules. We consider that it is a troubling development that in order to determine NZ tax treatment, a taxpayer will be forced to obtain tax advice in a foreign jurisdiction. The cost of obtaining tax advice in other jurisdictions can be excessive compared to New Zealand, and this will place an additional burden and increased compliance costs on businesses. In particular, tax advice will need to be sought on many cross border instruments or entities, as it may not be until the tax treatment in both jurisdictions is fully known, that a NZ taxpayer will know whether the instrument or entity is a hybrid and in the scope of the rules.
- 1.7 The burden placed on New Zealand businesses to obtain foreign tax advice is another reason for NZ not to adopt the full suite of hybrid proposals. It is also unclear how the IRD would plan to audit such transactions unless they also obtain their own foreign tax advice.

De-minimis threshold

- 1.8 As noted above, the complexity of proposals are likely to add significant compliance costs for impacted taxpayers. We submit that given this, there is merit in a de-minimis threshold being introduced so that transactions below a certain value would be exempt from the rules.
- 1.9 In the Group's view, the compliance costs of applying the hybrid rules are likely to be much higher than the potential revenue collected by IRD in many instances. Given that the risk to the tax base is lower on smaller transactions, it makes sense that the hybrid rules would be targeted only at higher-value transactions. We envisage that if the transaction value was below a particular level (e.g. \$1 million), the hybrid rules would not apply. This will ensure that the rules are more appropriately targeted at transactions where the tax revenue at stake justifies the compliance costs imposed on the business.

Economic analysis

- 1.10 Some of the economic claims made in Chapter 3 of the discussion document appear questionable and we would like to see what economic analysis has taken place in relation to these claims. Examples of these economic claims are:
- Paragraphs 3.4 and 3.5 note that organisations taking advantage of hybrid mismatch opportunities may lead to "welfare losses" and a "sub-optimal allocation of capital". Given it is widely acknowledged by economists that payment of tax gives rise to a deadweight (welfare) loss to society, it is questionable whether paying less tax actually gives rise to a welfare loss.
 - Likewise, paragraph 3.8 suggests the current situation "reduces worldwide welfare". However, if tax on the whole results in a deadweight loss, how can increasing corporate tax be a good thing in terms of increasing worldwide welfare? The only way to reduce the impact on NZ's overall economic welfare would be to introduce tax cuts to compensate for the increased tax collected in respect of hybrid entities or mismatch arrangements (if these proposals proceed), is this what paragraph 3.8 infers we should do?
 - Paragraph 3.19 hypothesises that investors using hybrids may be crowding out investors who would have otherwise invested via equity (and paid more NZ tax)



so NZ may be currently missing out on additional tax through the use of hybrids. However, it is likely that foreign investors will be seeking a certain after-tax hurdle return from their investment in NZ. If the NZ tax increases, they may pass this cost on to NZ consumers/customers or even pull out of NZ altogether if the hurdle is not met. This is the flip side to welcoming more foreign investment by keeping taxes on foreign investors lower (given NZ is a capital importing country).

- Para 3.27 seems to wrap all of the preceding analysis into a conclusion that companies that exploit hybrid mismatch rules are “subsidised” currently and that eliminating this misallocation (i.e. taxing more) will “increase worldwide efficiency”, leading to “higher worldwide incomes – which NZ will likely share in”. It is not clear how increasing the NZ tax take will lead to an increase in NZ’s share of worldwide income.

Further consultation and timeframe

- 1.11 It is the Group’s view that the current timeframe for advancing these proposals should be extended. Given the complexity of the proposals, more time should be invested into the policy development process to ensure that Officials and taxpayers can properly consider the implementation of the proposals. As noted above, this is particularly important given that the exact implications of the proposals are yet to be fully understood and fleshed out. In the Group’s view, it is crucial that time is taken to properly consider and address the issues and compare New Zealand’s position with that of other countries and debate some of the more complex issues associated with these proposals.
- 1.12 It is worth noting that the original draft UK legislation on hybrids, was 69 pages long. Even though the UK rules are not effective until 1 January 2017, we understand that the draft legislation has already been amended several times to fix holes in it. This illustrates that the devil will be in the detail and it will be really hard to gauge the impact of rules in absence of draft legislation.
- 1.13 In light of this, we **strongly recommend** that an exposure draft with draft legislation should be released for further consultation prior to including these proposals in a Tax Bill. It is only once the exact parameters of the proposals are understood that taxpayers can properly test the proposals in their own factual scenarios and understand whether they give rise to appropriate outcomes. Releasing an exposure draft will increase the likelihood that any unintended consequences/issues can be fixed before the proposals are introduced into parliament. It is very difficult to effect material change in legislation through the select committee process.
- 1.14 Consultation of this nature is not unprecedented in respect of tax legislation and will often occur with other types of legislation. In respect of tax legislation, Officials consulted with the Group and other stakeholders on the rules for accommodation allowances introduced in the Taxation (Annual Rates, Employee Allowances and Remedial Matters) Act. The Group would be pleased to provide feedback on an exposure draft (in confidence), prior to inclusion in a Tax Bill. However, our first preference would be for the exposure draft to be released publically for all to consult on, particularly given the wide reaching impact of these proposals to all taxpayers with foreign branches.



2. General rule for introduction

Effective date

- 2.1 The proposed application date is noted in paragraph 11.22 of the Discussion Document:

“The impact of the proposals will in most cases be able to be established now, by reference to the Final Report. We consider that the period from introduction of the relevant legislation to its enactment should give taxpayers sufficient time to determine the likely impact and accordingly the effective date of the legislation should be its enactment date. In accordance with the OECD recommendation, the provisions would then apply to payments made after a taxpayer’s first tax balance date following enactment.”

- 2.2 We do not agree that it is appropriate that these proposals should be effective from the date of enactment and apply to payments made after a taxpayer’s first tax balance date following enactment. In particular, we do not agree with the conclusion reached by Officials that the impact of the proposals is well established by now. Given the overload of policy reform in the past couple of years, it is an inappropriate conclusion to expect taxpayers to have considered the OECD reports in any great detail (given the reports in are many hundreds of pages long), particularly before there was any indication of how they may be adopted in New Zealand.
- 2.3 If the Government considers that New Zealand must implement these rules, it is important that New Zealand’s implementation date does not occur before other OECD member nations, particularly Australia’s. New Zealand does not need to act fast as these is little to be gained from being the first to adopt these proposals. If New Zealand does act early, we risk a material increase in compliance costs as taxpayers will need to analyse their arrangements and the current foreign tax treatment, monitor legislative changes in foreign jurisdictions, and adopt different treatments in New Zealand as changes progress overseas.
- 2.4 For example, consider a trans-Tasman hybrid mismatch arrangement with a D/NI outcome where a New Zealand entity is the payer and an Australian entity is the recipient. Under existing rules, payments are treated as deductible interest in New Zealand but a non-taxable dividend in Australia. The tax treatment of this arrangement would change over the life cycle of the financial instrument. In Year 1, if the hybrid rules are in force in New Zealand but not Australia, New Zealand would deny the deduction. In Year 3, if Australia moves to tax the dividend, the payment would be deductible in New Zealand.
- 2.5 In addition, some of the proposed rules are not applicable if the overseas jurisdiction has implemented hybrid rules (i.e. the imported mismatch rule). Adopting before other countries could therefore significant increase compliance costs in New Zealand in the years before other countries adopt that would not otherwise arise.
- 2.6 These examples illustrate that having rules come into effect in New Zealand ahead of other jurisdictions will result in significant changes in outcomes and unnecessary complexity and uncertainty. Given this, it is important that New Zealand aligns itself with other jurisdictions, in particular Australia, both in respect of key issues such as regulatory capital (the Group understands this issue is causing delay of these proposals in Australia) and the implementation date.



- 2.7 The current intended start of the hybrid measures in Australia is 1 January 2018 or 6 months after legislation has been passed. We suggest that Officials monitor developments in Australia and if there are delays in their hybrid rules being enacted, consider delaying the implementation date for the hybrid proposals in New Zealand until similar proposals are in force and bedded down in Australia.

Grandparenting and transitional period

- 2.8 We do not agree with the general proposition that there should be no grandparenting for these proposals. Significant investment decisions have been made based on existing settings and a lot of these arrangements involve external commitments (not necessarily internal group arrangements) that cannot be easily unwound. In the Group's view, a minimum grandparenting period of three years following date of enactment would be appropriate for existing arrangements (with potentially a longer grandparenting period for regulatory capital), to enable a transition to the new rules.
- 2.9 Even if Officials do not accept a grandparenting period for all existing arrangements, there is a good case for grandparenting in specific circumstances. One such instance where grandparenting treatment is warranted is regulatory capital. Again given our close ties to Australia, if Australia includes some form of grandparenting treatment for regulatory capital, in the Group's view it would be necessary for New Zealand to apply similar treatment.

3. Implementation of OECD recommendations in New Zealand

- 3.1 The next section in our submission considers the more technical aspects of the proposals. Given the sheer scope of these proposals, we do not comment on all the submission points in the discussion document, but focus on those that are of greater interest to our members.

4. Timing differences

- 4.1 As summarised in paragraph 5.22 and 5.23 of the Discussion Document, the OECD Final Report suggested approach for timing differences is:

"The Final Report suggests that a deduction should not be denied if the payment giving rise to the deduction is included in income in an accounting period that begins within 12 months of the end of the period in which the deduction is claimed. If this test is not met, the payer should still be entitled to a deduction if it can satisfy the tax authority that there is a reasonable expectation that the payment will be made within a reasonable period of time, and once made will be included in ordinary income. A reasonable period is one that might be expected to be agreed between arm's length parties. Final Report Example 1.21 applies these principles.

The Final Report does not provide for any denied deductions to be carried forward and allowed if and when the payee does recognise income."

- 4.2 The Australian Board of Taxation approach for timing differences is (as summarised in paragraph 5.25 of the Discussion Document):

The Australian Board of Taxation Report recommends a different approach. It suggests that a gap of up to three years between deduction and inclusion should not attract operation of the rule, whereas a longer



gap should mandatorily do so. It also suggests that any deduction denial should reverse when and if the payee recognises the corresponding income. This is essentially a carry-forward loss proposal. The proposal seems to mirror what would happen in the case of inclusion under the defensive rule. If the amount of a deduction in a payer jurisdiction were included in the payee's income under the defensive rule, and the payment giving rise to the income inclusion was later received, it would not be appropriate to tax the payment again, and rules against double taxation would generally achieve this. This supports the Board of Taxation carry-forward proposal in relation to the primary rule.

4.3 The Discussion Document seeks submissions on (Submission point 5C, page 42):

- *Whether the approach recommended by the Australian Board of Taxation would be an acceptable one for New Zealand;*
- *What alternatives might be better to deal with timing mismatches;*
- *What thresholds should apply to determine when the rule would apply to a difference caused by different income and expenditure rules."*

4.4 We agree with Officials that the Australian Board of Taxation approach would be preferable for New Zealand. This approach has advantages over the OECD approach as it is more certain by providing objective criteria for determining when there is a timing mismatch. In addition, it is a more reasonable approach as it allows denied deductions to be carried forward. It also seems sensible that a gap of up to three years between deduction and inclusion should not attract operation of the rule (particularly factoring in time delay between deductions being incurred, tax returns being filed, assessments being made of returns filed and any adjustments required being factored into required New Zealand provisional tax payments). For these reasons we support the Australian approach being adopted in relation to timing mismatches.

4.5 We comment later in the submission on the rules for carrying forward a deduction that has previously been denied.

4.6 The discussion document does recognise that the payee and payer countries may recognise income and expenditure from a financial instrument on a different basis (e.g. accrual or cash basis). However, it does not appear to consider how the rules may apply in situations where NZ recognises the treatment of interest and foreign exchange as a single item of Financial Arrangement income under our Financial Arrangement rules, as compared to other countries that might treat these amounts separately. We submit that further consideration needs to be given to this issue, and Officials need to provide further guidance on this in any further consultation on these proposals.

5. Taxation of FIF interests

5.1 Paragraph 5.48 and 5.49 of the Discussion Document notes:

"If a New Zealand resident holds shares subject to the FIF regime, and accounts for those shares using the fair dividend rate (FDR), cost or deemed rate of return (DRR) method, the dividends on those shares are not taxable. Instead the resident returns an amount of deemed income. Dividends are only taxable if the holder uses the comparative value (CV) or attributable foreign interest (AFI) method (note that when those two methods are being used, if the dividend is deductible in the



foreign country it will not be exempt in New Zealand even if the shareholder is a company).

FIF taxation therefore presents at least two problems for applying Recommendation 1.

- The non-resident payer of a deductible dividend to a New Zealand payee, if resident in a country with the hybrid rules, will not know how a New Zealand taxpayer of ordinary status would treat the dividend, and therefore will not know whether, or to what extent, it is denied a deduction for the dividend by the primary response in its own country.*
- When the New Zealand payee is applying the defensive rule (in a case where the non-resident payer of a deductible dividend has not been denied a deduction), if the payee is not applying the CV or AFI method, the payee will need to determine how much of the dividend has not been taxed, in order to know how much additional income to include."*

5.2 Paragraph 5.50 of the Discussion Document notes the possible solutions:

- deny the FDR, cost and DRR methods to shares on which any dividend would be deductible to the payer. This would be similar to the existing requirement to use the CV method for a non-ordinary (generally, debt-like) share (section EX 46(8));*
- include a deductible dividend in the holder's income, in addition to income already recognised under the FDR, cost or DRR method. This would be similar to the exclusion of deductible dividends from the general exemption for foreign dividends received by New Zealand companies in section CW 9 (though this exclusion does not apply to interests accounted for under the FDR, DRR or cost method);*
- include a deductible dividend in the holder's income only to the extent that it exceeds the income otherwise recognised on the shares. This is somewhat similar to the concept of a top-up amount (defined in section EX 60) that applies when a person uses the DRR method.*

5.3 Submission point 5E notes (at page 42):

"Submissions are sought on which of these FIF approaches would be preferable and why, and whether there is another better approach."

5.4 Our primary submission is that these FIF methods should not be altered in response to the hybrid proposals. This goes beyond the scope of the core policy concern and should not be an area of focus.

5.5 We note that there are a number of issues Officials will need to consider if they are to advance any of the proposed solutions noted above. In particular, ensuring that these rules do not inadvertently capture portfolio investments, including those held by PIEs and other widely held investment vehicles.

5.6 If one of these options does proceed, we suggest that the preferred approach should be the one that is the least complex and most straightforward to apply. Our preliminary view is that the first option appears to best meet this criteria however we would welcome further discussion with Officials on this if it is to be advanced.



6. Regulatory capital

6.1 Submission point 5H notes (at page 45):

"Submissions are sought on whether there are any issues with providing no exclusion for regulatory capital."

6.2 On this issue, paragraphs 5.59 and 5.60 of the Discussion Document note:

"The UK proposes to take up the option to exclude bank regulatory capital instruments from its regime in certain circumstances (see discussion at Chapter 8 of Tackling aggressive tax planning (HM Treasury and HMRC, December 2014). However, we understand that the UK has existing anti-hybrid rules that apply to bank regulatory capital. The Australian Board of Taxation Report sought an extension of time to report on this issue.

It is not proposed that bank regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand."

- 6.3 It is disappointing that Officials have provided no rationale for the proposed position in respect of regulatory capital. It makes it very difficult for stakeholders to consider the appropriateness of the position without understanding the rationale for such. We believe it would be in New Zealand's best interests to exclude regulatory capital from the scope of these proposals, as the inclusion of such is likely to increase the cost of capital in New Zealand.
- 6.4 We submit that in this area, New Zealand should closely monitor what Australia is doing. At a minimum, given our close ties to Australia, if Australia either excludes regulatory capital or regulatory capital is subject to grandfathering treatment, New Zealand should follow a similar approach.
- 6.5 Even if Australia does not adopt grandfathering treatment for regulatory capital, there are good reasons for adopting grandfathering treatment to provide financial institutions with a transitional period to adapt to the new rules. We understand that it can be difficult to wind up regulatory capital arrangements and that to do so will often require Reserve Bank approval (and there can be a number of hurdles to be met before such approvals are granted).
- 6.6 In light of this, we submit that there should be a grandfathering period of at least 5 years from the likely effective date (assuming these proposals are enacted in 2018). This would allow an orderly unwind of existing instruments, supporting investor confidence. This would ensure that the cost of capital is not pushed up through the need for multiple issuers to withdraw their issues and go to market for replacement funding at a similar time.
- 6.7 Any grandparenting treatment should apply to all regulatory capital issues prior to the date IRD released this discussion document. Prior to this date there was no certainty about how the IRD would land on regulatory capital, particularly since other jurisdictions are actively considering or applying carve outs for regulatory capital from their hybrid proposals.
- 6.8 In summary, we submit that at the very least, there should be some grandfathering treatment for regulatory capital, subject to any further developments in Australia.



7. Carry-forward of denied deductions

7.1 Submission point 6A notes (at pages 50-51):

"Submissions are sought on whether there are any issues with using the rules for the carrying forward of tax losses as a basis for the treatment of carrying forward disallowed deductions."

7.2 We do not support the existing loss carry forward rules being used as a basis for allowing the carry forward of disallowed deductions under the hybrid rules. In the Group's view, there are deficiencies with our existing loss carry forward rules and these operate in some instances to reduce the incentive for businesses to innovate and take risks and restricts the ability to introduce new capital into a business. Arguably, the loss carry forward rules should be more generous and should be not be used as the basis for loss carry forward for hybrid mismatch arrangements.

7.3 In addition, the purpose of our existing loss carry forward rules are designed to ensure that the same ultimate owner who bears the loss is ultimately able to utilise it.

7.4 In the context of hybrid mismatch arrangements, the same policy concerns are not as evident. If excess dual inclusion income is returned in a subsequent year, and deductions have been denied in a prior period, it is appropriate that this be offset to prevent double taxation, regardless of changes in ownership in excess of 51% during the total period. If Officials have concerns about loss trading, an anti-avoidance rule could be included in the rules to specifically combat this.

8. Carry-forward / reversal of defensive rule income

8.1 Paragraphs 6.25 to 6.27 of the Discussion Document note:

"The Final Report does not propose a carry-forward rule for the application of the defensive rule. This creates a potential for over-taxation in a scenario where the defensive rule is applied to include extra income in the payee country and excess dual inclusion income arises in a later year.

A solution to this problem may be to provide for a "reversal" rule whereby the application of the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income.

Alternatively, the defensive rule could be limited so that income is only included to the extent that the disregarded payment deduction is offset against non-dual inclusion income in the payer jurisdiction. In the event that there is no non-dual inclusion income that the payment can be offset against, the income inclusion could be suspended until non-dual inclusion income is present. Unlike the reversal approach, this option would require the payee country tax authority and payee jurisdiction taxpayers to be aware of the level of non-dual inclusion income being earned in the payer country."



8.2 Submission point 6C notes (at pages 52-53):

Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in this regard, and which approach would be best to take."

- 8.3 We agree that there should be some carry forward of defensive rule income. A "reversal" rule for the application of the defensive rule is the most straightforward and least complex approach. Despite this, we submit that the best way forward would be to allow taxpayers a choice of options. Where the taxpayer is aware of the level of non-dual inclusion income being earned in the payer country, they could elect to limit the application of the defensive rule. This ensures that the taxpayer is not forced to report income in the payee country which they know will ultimately be reversed.
- 8.4 However, taxpayers may not have the information to identify the level of non-dual inclusion income in the payer country or choose not to apply this approach due to the greater complexity involved. In this instance, taxpayers should be able to elect to apply the "reversal rule" to reverse the application of the defensive rule in a later period. Allowing an election of options will provide the most flexibility to ensure that taxpayers are not subject to double taxation.

9. Dual inclusion income

General comments

- 9.1 Dual inclusion income is a fundamental concept in the context of hybrid entities and branches. We believe this requires further consideration as to what would be and would not be dual inclusion income. While this appears to be a simple concept, there are some complexities such as foreign exchange gains/losses on loans which is unclear how this would be treated.
- 9.2 We believe that further consideration needs to be given to what is and what is not dual inclusion income. Officials need to provide further guidance on this concept in any further consultation on these proposals. Until there is clarity on key concepts such as this, taxpayers face difficulties in understanding how these proposals might apply to their existing structures.

CFC income as dual inclusion income

- 9.3 Paragraph 6.28 of the Discussion Document notes:

"As with Recommendation 1, it is proposed that CFC income is not able to be included as dual inclusion income. This will avoid drafting a large amount of very detailed and targeted legislation, aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise."

- 9.4 Submission point 6D notes:

"Submissions are sought on whether it is appropriate to depart from the OECD's recommendations in relation to CFC income as dual inclusion income."



- 9.5 We do not agree with the proposal to depart from the OECD’s recommendations in relation to CFC income as dual inclusion income. Just because it is difficult and/or complex to include CFC income as dual inclusion income is not an excuse to depart from the OECD proposals, especially since the OECD recommendations are likely to achieve a more appropriate outcome.
- 9.6 If the Government proceeds with the full suite of hybrid proposals, it is important that we have a comprehensive regime that seeks to get the right overall outcomes, and not draw a line in a taxpayer unfavourable manner. While it could be argued that taxpayers who are impacted by this proposal could simply use an alternative structure, in many instances structures are locked in or simply cannot be re-structured.

10. Reverse hybrid rule

- 10.1 Chapter 7 of the Discussion Document deals with reverse hybrids which is an entity whose income is treated as:

- Derived by its investors in its establishment country;
- Derived by the entity in the investor country.

Recommendation 4

- 10.2 Recommendation 4 is described in paragraphs 7.6 to 7.7 of the Discussion Document:

“Recommendation 4 is when a D/NI payment is made to a reverse hybrid, and the payment would have been included in income if it were made directly to the investor; the payer country should deny a deduction for the payment. The Recommendation also applies if the payment would have given rise to a hybrid mismatch under the hybrid financial instrument rule if made directly to the investor. As with the disregarded payments rule, this rule can apply to any deductible payment.

Taxation of an investor in its home country on a subsequent distribution by the reverse hybrid of the income does not prevent a payment being subject to disallowance under this Recommendation (Final Report, paragraph 156).”

- 10.3 Submission point 7A notes (at page 56):

“Submissions are sought on whether there are any issues relating to implementing Recommendation 4 in New Zealand”

- 10.4 These rules are extremely complex and we would question whether such a rule is a proportionate response to the issue. However, the Group strongly submits that CFC income should be respected as income of the payee to ensure there is no denial of a deduction where the income is recognised in the parent of the reverse hybrid as CFC income.

Recommendation 5.1 and 5.2

- 10.5 Chapter 7 of the Discussion Document includes Recommendations 5.1 and 5.2 which consider “CFC and other offshore investment regimes” and “taxation of reverse hybrids established in New Zealand” respectively.



- 10.6 According to paragraph 7.17 of the Discussion Document, recommendation 5.1 involves:

"This recommendation is for New Zealand to ensure that a payment to a CFC that is fiscally transparent in its establishment country with respect to the payment is caught by the CFC regime, that is, that it is taxed to New Zealand investors in the CFC, if those investors are subject to tax under the CFC regime. In this way, the CFC regime would be used to turn the reverse hybrid into an ordinary fiscally transparent entity, at least insofar as it allocates income to New Zealand investors."

- 10.7 We understand that recommendation 5.1 is focused on D/Ni outcomes and the proposals in para 7.19 are targeted at CFCs that are not recognising income in their own jurisdiction because they are treated as fiscally transparent, however a deduction has been taken in another jurisdiction for the payment to the CFC. We consider that payments giving rise to a D/Ni outcome are likely to be passive income rather than active income. Given the breadth of New Zealand's CFC regime, passive income is likely to be taxed to the New Zealand parent of a reverse hybrid CFC under the current rules. We also consider that any active income is also likely to be taxed in the jurisdiction in which it is earned, meaning that any rule applied in this area is likely to have limited application. There could be situation where the reverse hybrid is largely active and the minor passive income is not taxed in jurisdiction or as New Zealand CFC income. However such cases are likely to be minor and are the result of a deliberate policy decision that income of a CFC will not be attributed to New Zealand where passive income is less than 5% of total income.
- 10.8 Given the complexity in drafting such a rule and its limited application, the Group submits that it should not be advanced as it is not considered required.
- 10.9 If the rule is adopted, the UK approach suggested at para 7.24 should be available to taxpayers that are able to ascertain whether a deduction has been denied in a payer jurisdiction. That is, taxpayers that can ascertain this information should not be disadvantaged.

11. Deductible hybrid payments – Application to branches

- 11.1 Submission point 8 (at page 65) notes:

"Submissions are sought on whether the denial of a deduction for foreign branch losses against New Zealand income should be matched by an exemption for active income earned through a foreign branch. This would put foreign branches of New Zealand companies in a similar New Zealand tax position to foreign subsidiaries."

Submissions are also sought on any other aspect of the proposals relating to the implementation of the OECD's Recommendation 6 in New Zealand."

- 11.2 If the proposal to deny a deduction for a foreign branch loss does proceed, we believe that an active income exemption for foreign branch income is critical to remove the complexity that will otherwise arise for those taxpayers that cannot simply restructure out of the use of a foreign branch.
- 11.3 Further, if these proposals do proceed, aspects of these will be need to be clarified. In relation to foreign branch losses, Paragraph 8.6 of the Discussion Document is not entirely clear on how these proposals will apply in practice. It is noted that "unless



it can be shown that such an offset is not possible”, losses will have to be carried forward.

- 11.4 The question that arises is: When is an offset not possible? If we take an example of a New Zealand company with a branch in Australia, presumably this will be when there is no other Australian income to offset against. This could occur when the New Zealand resident entity does not have any other business operations in the other jurisdiction. However, what if the New Zealand entity later acquires a business in the other jurisdiction which it can offset the loss against? For example, consider an example where in Year 1, a New Zealand entity has no income in Australia to offset the loss incurred by its Australian branch. In Year 2, the New Zealand entity now has Australian income due to acquisition of another business. In Year 1, the NZ entity would not have known that it would have income in Australia in Year 2. Would this situation meet the criteria of being “not possible” for those losses to be offset against other Australian income? We require further clarification of how the Discussion Document proposals are intended to apply in this scenario.



APPENDIX TWO: FURTHER QUESTIONS

Para	Discussion Document extract	Issue
4.11	So, for example, a cross-border lease payment by a resident under an operating lease is not subject to this rule, even if the lessor country treats the lease as a finance lease.	<p>Assume the same position if:</p> <ul style="list-style-type: none"> • the lessee treats as a finance lease • both countries treat as a finance lease?
4.14	This rule only applies to payments between related parties (broadly, 25 percent or more common ownership) or under structured arrangements.	<p>When investing into listed entities there are various rules prohibiting disclosure of information, even when greater than 50% is owned. How is this addressed?</p> <p>Also, when you own less than 50% outside the listed company scenario, how are restrictions of information to be addressed?</p> <p>How is 25% test to be measured (voting, dividend or some other basis?)</p>
4.18	So, for example, if a hybrid entity makes a deductible payment to its foreign parent, and that payment is disregarded in the parent country because it treats the hybrid entity as a part of the parent, then <i>prima facie</i> the country where the hybrid is resident should deny a deduction for the payment. If it does not, the parent country should tax the payment. Neither response is required if the hybrid entity in the same year derives an equal amount of income which is taxed in both countries (that is, is dual inclusion income).	What happens if the branch is in losses, this seems to suggest that must have an equal amount of income?
5.12	Subject to two exceptions (considered below), countries only need to apply this rule to payments under financial instruments as characterised under their own domestic law . So, for example, a cross-border lease payment by a New Zealand-resident	If there is a finance lease in NZ, could this be a hybrid instrument?



Para	Discussion Document extract	Issue
	<p>under a lease that is not a financial arrangement would not be subject to disallowance under this rule, even if the lessor country treats the lease payment as partially a return of principal under a finance lease.</p>	
5.17	<p>Only hybrid mismatches that arise as a result of the terms of an instrument are relevant. For example, if a New Zealand borrower pays interest to a related party who is tax-exempt, there will be no hybrid mismatch if the related party would have been taxable on the interest were it not tax-exempt. However, there will be a hybrid mismatch if the related party would not have been taxable on the interest if it were not tax-exempt (Final Report, Example 1.5).</p>	<p>How is this determined? How is the counterfactual established?. The tax treatment of an individual or a corporate or a trust or a collective investment vehicle (or various elections thereon) may all give different results. How is this addressed?</p>
5.21/5.23 5.25	<p>Where the payer and payee under a financial instrument are in different jurisdictions, it is not uncommon for them to recognise income/expenditure from the instrument on different bases. For example, a payer may be entitled to a deduction for a payment on an accrual basis, whereas a payee is taxable on a cash basis. In that case, there is a hybrid mismatch, which is <i>prima facie</i> subject to Recommendation 1.</p> <p>...</p> <p>The Final Report does not provide for any denied deductions to be carried forward and allowed if and when the payee does recognise income.</p> <p>...</p> <p>The Australian Board of Taxation Report recommends a different approach. It suggests that</p>	<p>What happens with the following:</p> <ul style="list-style-type: none"> • Deduction is removed due to FX gains. • Deduction is accrual of a premium on the bond paid to another person (e.g. shareholder buys market debt for a premium, it will have deductions and no income to subsidiary company). • Deduction is due to capitalization of establishment costs. • Deduction reverses over life of instrument and is greater than 3 years?



Para	Discussion Document extract	Issue
	<p>a gap of up to three years between deduction and inclusion should not attract operation of the rule, whereas a longer gap should mandatorily do so. It also suggests that any deduction denial should reverse when and if the payee recognises the corresponding income.</p>	
<p>5.37 & figure 5.3</p>	<p>The substitute payment is the premium portion of the amount paid by A Co to B Co for the transfer of the bond with accrued interest. The transfer is neither a financial instrument, nor a hybrid transfer. However, the premium is a payment in substitution for the payment of the accrued interest. It is deductible to A Co and treated as a capital gain to B Co, so it gives rise to a hybrid mismatch. On the facts of the example, the payment by A Co to B Co is a substitute payment because the payment of the coupon to the vendor would itself have given rise to a hybrid mismatch. The result would be the same if the coupon payment were taxable to the vendor. Accordingly, if the purchaser and vendor are related, or the sale is a structured arrangement, the payment of the premium will be subject to the hybrid mismatch rule.</p>	<p>What payment is taxable to B Co? How would B Co know, or the IRD know?</p>
<p>5.50</p>	<p>Possible solutions are to:</p> <ul style="list-style-type: none"> deny the FDR, cost and DRR methods to shares on which any dividend would be deductible to the payer. This would be similar to the existing requirement to use the CV method for a non-ordinary (generally, debt-like) share (section EX 46(8)); 	<p>Is the CV treatment being proposed, or simply a move back to dividend only treatment? What happens if less than \$50,000 FDR exemption applies? What if the NZ shareholder has no knowledge of the tax treatment of the dividend or whether the payer applied these rules?</p>



Para	Discussion Document extract	Issue
5.50	<ul style="list-style-type: none"> include a deductible dividend in the holder’s income, in addition to income already recognised under the FDR, cost or DRR method. This would be similar to the exclusion of deductible dividends from the general exemption for foreign dividends received by New Zealand companies in section CW 9 (though this exclusion does not apply to interests accounted for under the FDR, DRR or cost method); 	<p>What is the logic to tax both FDR and the dividend? Why is the option of doing nothing not viable?</p> <p>What does the comment in Yellow highlight mean?</p>
5.50	<ul style="list-style-type: none"> include a deductible dividend in the holder’s income only to the extent that it exceeds the income otherwise recognised on the shares. This is somewhat similar to the concept of a top-up amount (defined in section EX 60) that applies when a person uses the DRR method. 	<p>How are corporate restructures to be treated? What happens if the higher dividend does not occur each year?</p>
5.52	<p>Recommendation 1 could apply to an asset transfer involving a New Zealand party. For example, suppose a New Zealand resident purchases an asset from a related party on deferred payment terms, and is entitled to deduct a portion of the price as financial arrangement expenditure. If the vendor treats the entire amount as being from the sale of the asset, then there will be a hybrid mismatch, and the purchaser will be denied a deduction for the expenditure.</p>	<p>What if the vendor held the asset on revenue account (e.g. it was a significant item of trading stock) or was subject to capital gains tax in their jurisdiction?</p> <p>What if the asset is depreciable property?</p> <p>What if it is not known what the vendor’s treatment is?</p>
7.8/7.10	<p>Many trusts – for example, most family trusts, do not have investors as such. For the purposes of this rule, an investor is any person to whom income is allocated by a reverse hybrid. So it</p>	<p>How is a control group determined for a Trust? (see also 7.30 below).</p> <p>How can a discretionary beneficiary have any control or exert any influence?</p>



Para	Discussion Document extract	Issue
	<p>would include any person who is allocated beneficiary income.</p> <p>....</p> <p>The rule only applies if either:</p> <ul style="list-style-type: none"> • the investor, the reverse hybrid and the payer are members of the same control group; or • the payment is under a structured arrangement to which the payer is a party. 	<p>Para 7.11 refers to the definitions in chapter 12, chapter 12 states that it needs to be defined?</p>
7.9	<p>The Recommendation will not apply if the reverse hybrid establishment country taxes as ordinary income the income allocated to the non-resident investor – for example, on the basis that the reverse hybrid is carrying on business in the establishment country.</p>	<p>How can a trustee always know what the foreign tax rules of a beneficiary is?</p>
7.13	<p>Countries should tax reverse hybrids established in their own country to the extent that their income is allocated to non-residents who are not taxable on the income because they are resident in a country that treats the reverse hybrid as fiscally opaque. This recommendation would only apply if the non-resident investor is in the same control group as the reverse hybrid.</p>	<p>If there is no control group, presumably there is no reverse hybrid?</p>
7.16/12.5 /12.7	<p>From the perspective of other jurisdictions making payments to New Zealand, we note that a foreign investor PIE would seem to be a reverse hybrid, depending on the treatment of the investors in their home countries (see Final Report, paragraphs 161 and 162). However, a payment to a foreign investor PIE would not be subject to disallowance in most cases, due to the scope limitation of Recommendation 4.</p>	<p>Why would a foreign investor PIE not have a purpose or effect of producing a hybrid mismatch?</p>



Para	Discussion Document extract	Issue
	<p>...</p> <p>The definition of a “structured arrangement” is set out in Recommendation 10 of the Final Report, and discussed in some detail. The core definition is that it is an arrangement where either:</p> <ul style="list-style-type: none">• the hybrid mismatch is priced into the terms of the arrangement; or• the facts and circumstances indicate that it has been designed to produce a hybrid mismatch. <p>To incorporate this definition into New Zealand law, it is proposed to use the existing “arrangement” definition, and to define a structured arrangement as one where either:</p> <ul style="list-style-type: none">• the hybrid mismatch is priced into the terms of the arrangement; or• the arrangement has a purpose or effect of producing a hybrid mismatch.	
7.18	<p>One way to address this would be to treat any person who has an interest in a CFC, as determined under subpart EX, to derive an amount of income from the CFC equal to the amount allocated to that person by the reverse hybrid for income tax purposes in its establishment country, and which is not taxed in the establishment country because of that allocation. This figure will already have been calculated by the CFC, and so should be readily available to the investor. In the case of an entity that is only partially transparent</p>	<p>What does this mean?</p> <p>How does this apply to ordinary dividends received by the reverse hybrid?</p> <p>Why will these amounts already have been calculated by the CFC and now available to the investor?</p> <p>Can we have a fully worked example what this is aimed at?</p>



Para	Discussion Document extract	Issue
	only the untaxed income would be subject to the CFC regime.	
7.29	<p>There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand’s right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.</p>	<p>What sense are we allocating income to a non-resident settlor? For example, if a foreign Trust has NZ sourced income, it is subject to NZ tax, there is no allocation to any settlor?</p> <p>How is a foreign trust a reverse hybrid when it gets a legislative tax exemption on foreign source income?</p> <p>When would the settlor be in the same control group as the Trust?</p> <p>What if the Trustee does not know how each beneficiary is taxed in each foreign jurisdiction where beneficiaries reside? What if beneficiaries do not reside in any country?</p> <p>What is the income? Is it dividend income, FIF income, or CFC income? For example, where foreign trust has FIF and CFC interests and the non-resident beneficiaries are only taxed on dividend income?</p> <p>What if the countries of the beneficiaries do not tax foreign sourced income?</p> <p>Why are these proposals overriding existing tax structures without consultation on why this is occurring? (Foreign Trusts and foreign PIEs)</p>
7.30	<p>The definition of a “control group” is discussed in more detail in Chapter 12. The definition is designed to apply to partnerships and trusts as well as to corporate groups. Example 11.1 of the Final Report demonstrates that:</p>	<p>Appointment of trustee gives rise to what percentage of voting interests? What else makes up voting interest in a foreign trust?</p>



Para	Discussion Document extract	Issue
	<ul style="list-style-type: none"> the power to appoint a trustee of a trust is treated as a voting interest in the trust; where a settlor’s immediate family are the beneficiaries of a trust, they will be treated as holding equity interests in the trust, and these equity interests will be deemed held by the settlor under the “acting together” test. 	<p>Family members will be deemed as holding equity interest in the trust. What does this mean?</p> <p>What percentage is this compared to all possible beneficiaries?</p> <p>What happens if there are multiple settlers, settlers who are deceased or do not exist?</p> <p>What are immediate family members?</p>
8.6	<p>The primary response means that in most cases a New Zealand resident will not be able to claim an immediate deduction for a foreign branch loss except against income from the same country. This is because in most cases it will be possible for those losses to be used to offset non dual-inclusion income in the branch country. Unless it can be shown that such an offset is not possible, those losses will have to be carried forward and used either:</p> <ul style="list-style-type: none"> to offset net income from the branch in future years; without restriction, if the losses have become unusable in the branch country, for instance because the branch has been closed down before the losses have been used or because of an ownership change. In this case the losses are referred to as “stranded losses”. 	<p>Why most cases?</p> <p>In most cases of a foreign branch, the only activity in that jurisdiction will be the foreign branch, i.e. there will be no other activity.</p> <p>Where there is only a single foreign branch operation, what is the other dual-inclusion income in the branch country?</p> <p>What is the definition of a branch?</p>
Submission point 8	<p>Submissions are sought on whether the denial of a deduction for foreign branch losses against New Zealand income should be matched by an exemption for active income earned through a</p>	<p>What is proposed in relation to the possible branch exemption?</p> <p>When would it apply from?</p>



Para	Discussion Document extract	Issue
	<p>foreign branch. This would put foreign branches of New Zealand companies in a similar New Zealand tax position to foreign subsidiaries.</p>	<p>What realizations would occur on moving from existing branch tax to exemption regime? Would trading stock gains, depreciation recoveries etc. be realized?</p> <p>What will be included as a branch?</p> <p>Will the existing active/passive rules apply to the branch?</p> <p>What is the FX treatment of investment into the branch?</p>
10.7		
10.10	<p>As it is part of the OECD recommendations, it is proposed that New Zealand should introduce an imported hybrid rule. Multinational groups with Australian or UK members will already need to be keeping track of uncorrected hybrid mismatches for the purpose of compliance with the rules in those countries, so the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context.</p>	<p>Presumably Officials agree there are significant compliance costs for groups outside UK and Australian ownership?</p> <p>How is the IRD going to audit this?</p>
11.4	<p>In accordance with the OECD recommendations, we propose that denial of a deduction for a payment under any of the hybrid rules would not affect its withholding tax treatment.</p>	<p>Can you confirm the resulting tax payable would be treated as imputation credits for a company eligible to maintain an ICA?</p> <p>Will deductible payments be able to be fully imputed? If not, why not and how does the added layer of tax (28% plus additional withholding) be justified?</p>
12.12-14	<p>An investment in an entity can be a voting interest or an equity interest or both. A voting interest can</p>	<p>What is the proposed standalone definition?</p>



Para	Discussion Document extract	Issue
	<p>apply to non-corporate as well as corporate entities, and is a right to participate in decision making concerning distributions, changes in the person's constitution or the appointment of a director, broadly defined so that includes the persons who have management and control of an entity.</p> <p>A look-through test applies to trace interests through interposed entities.</p> <p>This approach is similar to that taken to determining whether or not two companies, two natural persons, and a company and a person other than a company, are associated under subpart YB 2 to YB 4 and YB 13 and YB 14, subject to the fact that for two companies, the test generally requires a 50 percent common ownership. However, the application to trusts and partnerships seems somewhat different. While it would make sense to build so far as possible on existing definitions, it is likely to be preferable to do so by using a stand-alone definition which combines existing concepts plus the modifications necessary to ensure that New Zealand's hybrid regime has the same scope as others enacted in accordance with Action 2.</p>	<p>What existing concepts will be used?</p> <p>How do you apply voting measurements to a discretionary structure where distributions and membership (i.e. beneficiaries) are totally discretionary?</p>



11 November 2016

c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Policy.webmaster@ird.govt.nz

Dear Deputy Commissioner,

Submission on the discussion document "Addressing hybrid mismatch arrangements"

Thank you for the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on the Government Discussion Document on Addressing Hybrid Mismatch Arrangements (the **Discussion Document**).

As an opening comment ANZ Bank New Zealand Limited (**ANZ**) supports the work being undertaken by the OECD to address real concerns over base erosion and profit shifting (**BEPS**). However, any measures implemented by New Zealand to address these concerns need to be co-ordinated at a multilateral level to ensure that New Zealand corporates are not placed at a competitive disadvantage.

In the context of anti-hybrid rules potentially to be adopted by New Zealand, ANZ considers that they should meet the following the broad principles:

- i) be certain, clear and simple in scope and effect;
- ii) not lead to impractical or excessive compliance requirements or unintended consequences;
- iii) implementation should be consistent with New Zealand's major trading partners (particularly Australia) to ensure no adverse tax consequences for New Zealand's competitiveness;
- iv) recognise the need for Reserve Bank of New Zealand (**RBNZ**) regulated financial institutions, including banks, to issue hybrid capital to manage prudential requirements; and
- v) be sufficiently flexible to accommodate the frequent changes in the regulatory environment in which the banking system operates.

Summary of key submission points

ANZ's submissions centre on the possible impacts from the anti-hybrid proposals on bank regulatory capital and ANZ's branch arrangements. Our submissions are summarised below and we provide further context to our submissions in Appendix 1. We also summarise in Appendix 2 key bank regulatory capital obligations. ANZ considers it important that the purpose of these regulations is borne in mind in light of the potential disruption the anti-hybrid mismatch proposals may have on banks' regulatory capital.

1. ANZ submits that bank regulatory capital should be grand-parented from the anti-hybrid mismatch proposals for any bank regulatory capital issued prior to the date of enactment of any proposals or, at the earliest, prior to the date of release of the Discussion Document.
2. Any proposal to apply anti-hybrid mismatch rules to bank regulatory capital should be aligned, both in design and implementation dates (if the submission above is not accepted), to any proposals Australia may implement on bank regulatory capital. Aligning with Australia will assist in mitigating what could otherwise be excessive disruption (and possibly cost) to holders of impacted bank regulatory capital (which predominantly are retail holders), banks (in respect of ensuring compliance with prudential regulations) and prudential regulators.
3. ANZ is concerned that the second limb of the proposed definition of "structured arrangement" could capture all banking regulatory capital (other than common equity tier 1 capital) given the equity component in such instruments that arises from complying with the RBNZ framework. Such an outcome has the potential to impose excessive compliance costs upon banks. ANZ submits that the second limb of the definition of "structured arrangement" requires more detailed clarification to mitigate this risk.
4. Further consultation should occur before any legislation is drafted on the proposals. Also, any draft legislation should be made available to interested parties for comment prior to introduction of a Bill into Parliament. The proposals are complex and so will be any legislation on the proposals. To ensure any legislation from the proposals is certain, clear and simple with minimal compliance burden and minimal impact to underlying bank prudential regulation, a high degree of ongoing consultation will be required.
5. ANZ is concerned that the proposals may impact existing bank branch structures in respect of the underlying nature of how they are taxed, which, if this was the case, we consider would be an inadvertent outcome. It is uncertain from the Discussion Document whether or not this is the case. ANZ recommends further consultation occur to specifically address whether the existing bank branch structures are intended to be captured by any anti-hybrid proposals.

About ANZ

ANZ is the largest financial institution in New Zealand and is subject to the RBNZ's prudential supervision. The ANZ group comprises brands such as ANZ, UDC Finance, ANZ Investments, ANZ New Zealand Securities and Bonus Bonds.

ANZ offers a full range of financial products and services including a significant range of financial advisory services, personal banking, institutional banking and wealth management services.

Publication of submission

ANZ requests that this submission on the Discussion Document is kept confidential by the IRD on the grounds of commercial sensitivity.

Contact for submission

ANZ welcomes the opportunity to discuss any of our submissions directly with IRD officials. Please contact me on 9(2)(a) [REDACTED] if you would like to discuss our submission further.

Once again, we thank the IRD for the opportunity to have input into the proposals on addressing hybrid mismatch arrangements and look forward to ongoing consultation on this topic.

Yours sincerely



Philip Leath
GM Tax, New Zealand
ANZ Bank New Zealand Limited

APPENDIX 1 - Submission points

As the IRD are aware, Australia and New Zealand Banking Group Limited (**ANZBGL**), the Australian parent bank, has issued an Additional Tier 1 regulatory capital instrument primarily to the Australian retail market via its branch operations in New Zealand. This capital represents level 1 Additional Tier 1 regulatory capital for ANZBGL (i.e. as a standalone Approved Deposit Taking Institution) and is regulated by the Australian prudential regulator (**APRA**). The RBNZ framework requires regulatory capital issued by a special purpose vehicle to, in essence, be mirrored with regulatory capital issued by the New Zealand regulated bank. As such, ANZ has issued regulatory capital (on similar terms as the Additional Tier 1 issued by the New Zealand branch of ANZBGL) to the New Zealand branch of ANZBGL. This capital represents Additional Tier 1 regulatory capital for ANZ and is regulated by RBNZ. Both issuances of this capital are regulated by multiple other regulators, including rulings from both the Australian Tax Office and IRD.

1. Bank regulatory capital should be grand-parented from the anti-hybrid mismatch proposals for any bank regulatory capital issued prior to the date of enactment of any proposals or, at the earliest, prior to the date of release of the Discussion Document.

1.1 Paragraph 11.20 of the Discussion Document proposes a general rule for introduction of the proposal, being:

*"The hybrid rules are intended to apply to all payments made after the effective date of the implementing law. This effective date should be far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse consequences (Final Report, paragraph 311). **Since the rules generally apply to arrangements between related parties or within a control group, restructuring arrangements should not be as difficult as it might otherwise be.** Furthermore, the result achieved by the rules should not generally be a punitive one, rather it involves the loss of an unintended tax benefit. The Final Report also suggests that the rules should generally take effect from the beginning of a taxpayer's accounting period."*

[Emphasis added]

1.2 ANZ considers that the principle for determining implementation timeframes should be to limit market and regulatory disruption, which would occur if there was a requirement for bank regulatory capital to be refinanced.

1.3 In light of this principle, ANZ recommends a more cautious approach be applied to bank regulatory capital than simply applying the general rule above. Given the idiosyncratic nature and systemic importance to the New Zealand banking system of bank regulatory capital (including the "frankable/ deductible" bank regulatory capital), ANZ submits a grand-parenting should exist from the anti-hybrid mismatch proposals for any bank regulatory capital issued prior to the date of enactment of the amending legislation or, at the earliest, prior to release of the Discussion Document. There has been no tangible certainty of New Zealand's response to the OECD's recommendations on hybrid instruments until the Discussion Document was released and, arguably, uncertainty still remains. This is particularly so in light of the Australian Board of Taxation still deliberating on this very topic.

- 1.4 The so called “frankable/ deductible” bank regulatory capital, as referred to in the Discussion Document, are issued to retail holders and not related parties. This very point is acknowledged by the Discussion Document at paragraph 2.14, but appears to have been omitted from paragraph 11.20, as above. It will be critical that this public retail market remains available to banks. As such, ANZ considers it preferable that existing issuances are grand-parented to minimise market (i.e. investor) disruption.
- 1.5 ANZ also notes that, generally, bank regulatory capital must be replaced with equivalent or higher ranked bank regulatory capital (refer BS16). It may not be possible to “restructure existing [bank regulatory capital] arrangements to avoid any adverse consequences” as is suggested in paragraph 11.20 of the Discussion Document. This is due to a combination of both:
- a) The inherent hybrid nature of bank regulatory capital, which arises from the relevant conversion requirements of the regulations which gives such instruments an equity component; and
 - b) That it may be undesirable, commercially, to call the instruments. This undesirability arises from both a reputation risk (in that banks need access to multiple markets to issue regulatory capital) and, if many banks call some of their regulatory capital instruments in a similar timeframe as a result of the proposals, significant liquidity and pricing issues will arise from any replacement of the regulatory capital.
- 1.6 In the absence of grand-parenting, any restructure of existing instruments would require approvals from multiple regulators. Such regulators include APRA and RBNZ, as well as relevant tax authorities amongst others. Such approvals would require significant lead-in time and, ANZ considers, could not commence until, potentially, the enabling legislation is enacted or at least substantively certain of enactment (for example, it may be necessary to obtain relevant tax rulings on any restructure, which could not commence until the enabling legislation was enacted).
- 2. Any proposal to apply anti-hybrid mismatch rules to bank regulatory capital should be aligned, both in design and implementation dates (if the submission above is not accepted), to any proposals Australia may implement on bank regulatory capital.**
- 2.1 The OECD’s proposed hybrid mismatch rules focus on alignment between different countries’ tax treatments in respect of hybrid arrangements. The effect of the proposed linking rules is that the tax treatment in New Zealand will materially depend on the tax treatment in other relevant countries, particularly Australia in the case of the frankable/ deductible bank regulatory capital.
- 2.2 However, the position Australia will take on bank regulatory capital remains uncertain. The Australian Board of Taxation has been tasked with undertaking a further review of the impact of anti-hybrid mismatch proposals on bank regulatory capital and, as at the date of this submission, is still due to report back to the Australian Treasurer on this topic.

2.3 Harmonising anti-hybrid mismatch proposals between Australia and New Zealand for bank regulatory capital will minimise market and regulatory disruptions from any restructuring of such bank regulatory capital to prudential regulators on both sides of the Tasman, investors, banks and other relevant regulators. More specifically, harmonisation will provide greater certainty on how and when to restructure (including redeeming) any existing bank regulatory capital than would be the case if harmonisation did not occur. To put this position more colloquially, to restructure only once in an integrated and trans-Tasman co-ordinated fashion makes more sense than presenting a possible risk of having to do so twice and also aligns with the OECD multilateral focus.

2.4 Further, we understand the Australian Board of Taxation is reviewing whether distributions paid on Additional Tier 1 capital should be treated as deductible distributions (as opposed to the current position which treats Additional Tier 1 as non-share equity). Such an approach would align the tax treatment of Additional Tier 1 capital with the prudential classification, be consistent in tax treatment with many of the G20 countries on Additional Tier 1 capital, de-risk the Australian financial system by opening access to new markets (i.e. increasing liquidity) and remove the current tax hybrid outcomes between Australia and New Zealand. If this were to be the case, it may become appropriate for New Zealand to exclude bank regulatory capital from the anti-hybrid mismatch proposals.

3. ANZ submits that the second limb of the definition of “structured arrangement” requires more detailed clarification to mitigate the risk that all banking regulatory capital (other than common equity tier 1 capital) is treated as a “structured arrangement”.

3.1 Chapter 4 of the Discussion Document proposes that, in respect of financial instruments, the anti-hybrid mismatch rules apply to payments between related parties or under “structured arrangements”. The proposed definition of “structured arrangements” is very broad and highly subjective, being one where either:

*“the hybrid mismatch is priced into the terms of the arrangement;
or*

the arrangement has a purpose or effect of producing a hybrid mismatch.”

3.2 ANZ is concerned that all Additional Tier 1 and Tier 2 bank regulatory capital could be captured by the second limb of this very broad and subjective definition. This is because such bank regulatory capital must contain a loss absorbency trigger, via either an unequivocal conversion into ordinary shares of the New Zealand registered bank (or Parent) or an unequivocal write-off. Due to the “regulatory haircut” that arises from write-off, it is highly preferable that a conversion occurs for bank regulatory capital. It is this very conversion feature (a requirement of bank prudential regulations) that can create a hybrid instrument. Uncertainty, therefore, exists as to whether Additional Tier 1 or Tier 2 bank regulatory capital would be classified as a “structured arrangement”.

3.3 Uncertainty of tax outcomes is extremely unhelpful when raising bank regulatory capital. The tax outcomes of bank regulatory capital need to be certain prior to issuance in order to obtain the necessary non-objection notices from APRA and RBNZ issuances to be classified as bank regulatory capital.

3.4 ANZ submits that any legislation in respect of the proposals specifically exclude bank regulatory capital from the second limb of the "structured arrangement" definition. Another, more narrow approach, may be to exclude the relevant conversion scenarios (including loss absorbency, mandatory conversions and optional conversions) as imposed by bank prudential regulations from being "*an arrangement [that] has a purpose or effect of producing a hybrid mismatch*". ANZ strongly recommends such exclusion is incorporated into legislation (rather than, say, guidance) to provide utmost certainty, which is highly important when raising bank regulatory capital.

4. Further consultation should occur before any legislation is drafted and any draft legislation should also be made available to interested parties for comment prior to introduction of a Bill into Parliament.

4.1 The Discussion Document (at paragraph 4.10) suggests that the hybrid mismatch rules may be contained in a separate subpart in the Income Tax Act 2007. Given the nature of BEPS and hybrid arrangements, we expect that the legislation will be very complex.

4.2 ANZ submits that, given this complexity, it will be critical that further detailed consultation on the proposals occur prior to any drafting of legislation. Further, ANZ submits that any draft legislation is circulated to interested parties for review prior to the relevant tax bill being introduced into Parliament.

4.3 Reviewing the legislation at the select committee stage would be insufficient for such complicated tax reform for interested parties, the IRD and Parliamentarians. It is also critical that a "right first time" approach is adopted, particularly given the terms and conditions of various financial instruments (including bank regulatory capital issued to the public) are likely to be required to reflect the very precise terms of any legislation.

5. ANZ recommends further consultation occur to specifically address whether the existing bank branch structures are intended to be captured by any anti-hybrid proposals.

5.1 As highlighted above, the proposals in the Discussion Document are highly complex. Further, ANZ considers their application to be uncertain in respect to whether or not some of the proposals may impact existing bank branch structures.

5.2 ANZ notes that its existing branch structures (both onshore and offshore branches) are subject to the well-established permanent establishment attribution rules within New Zealand's double tax agreements. In summary, these rules result in the country in which the permanent establishment (or branch) exists to have the primary taxing rights with the country of the Head Office having the secondary taxing right. ANZ considers such an outcome to reflect the economic arrangements and, as no non-inclusion/ deductible, double deduction or indirect deduction/ no inclusion outcome arises, is sufficiently disconnected from the BEPS concerns of the OECD.

- 5.3 However, as noted above, due to the complexity and uncertainty of the proposals, it is highly difficult to determine whether the proposals may adversely impact existing bank branch structures. ANZ recommends the IRD undertake explicit consultation if it intends that the proposals will impact existing bank branch structures, particularly in light of the initial "surprise" that occurred when the NRWT proposals were initially announced and the systemic importance of such branch structures to the New Zealand banking system.

APPENDIX 2 - Bank regulatory capital

The summary below focuses on the high level requirements of the minimum capital that New Zealand registered banks are required to maintain. These requirements are designed to enhance the security of the New Zealand banking system against, amongst other things, systemic risk of the economy. ANZ considers it important that the purpose of these bank capital regulations is borne in mind in light of the potential disruption the anti-hybrid mismatch proposals may have on these requirements and associated regulatory obligations.

The RBNZ introduced the common framework for determining the appropriate level of bank regulatory capital as set by the Basel Committee (referred to as the Basel III framework) from January 2013. This framework requires New Zealand incorporated banks to comply with minimum capital ratios, as calculated by the amount of capital that must be held in relation to risk-weighted exposures (including market and operation risk).

In addition, since January 2014, a bank that does not maintain a common equity buffer ratio of 2.5% above the minimum levels faces restrictions on distributions it can make. This part of the buffer represents the "conservation buffer", that is part of the Basel III framework.

The size of this required buffer ratio may be increased by the RBNZ to take account of macroeconomic risks that pose a risk to the New Zealand financial system (which represents the "counter-cyclical buffer", that is also part of the Basel III framework). At present, the combined minimum capital ratios are:

Minimum Capital Ratios	Common Equity Tier 1	Total Tier 1 Capital	Total Capital
Basel III Minimum Capital Ratio	4.5%	6.0%	8.0%
Conservation Buffer	2.5%	2.5%	2.5%
Total Capital ratio	7.0%	8.5%	10.5%

Very broadly, bank capital refers to the funding of a bank that is available to absorb financial losses that the bank may suffer, without depositors and general creditors necessarily suffering losses. It includes the accounting equity of the bank group and also certain qualifying instruments.

ANZ is accredited to apply the RBNZ's "Capital Adequacy Framework (Internal Models Based Approach)" (**BS2B**) to calculate its capital ratio requirements. The key requirements of the capital to be applied in calculating the minimum capital ratio levels can be summarised in the following table.

Key requirements	Common Equity Tier 1	Additional tier 1 capital	Tier 2 Capital
Subordination	Most subordinated claim in liquidation of bank	Subordinated to depositors, general creditors and other subordinated debt of bank	Subordinated to depositors and general creditors
Permanence	Principal is perpetual with no set redemption date	Principal is perpetual but instrument may be redeemable after five years or when a tax or regulatory event occurs (redemption requires regulator consent)	Initial term must be at least five years, but may be redeemable after five years or when a tax or regulatory event occurs (redemption requires regulator consent)
Flexibility of payment	Distributions are non-obligatory and non-cumulative	Distributions are non-obligatory and non-cumulative	Distributions are deferrable but may be cumulative
Loss Absorbency	Absorbs losses on a going concern basis	Principal loss absorption if the CET1 ratio of the banking group falls below 5.125% (if classified as a liability) and on occurrence of non-viability trigger event	Principal loss absorption on occurrence of non-viability trigger event

Common Equity Tier 1 capital comprises ordinary shares, retained earnings and reserves less certain deductions, as stipulated by BS2B.

Additional Tier 1 capital loss absorbency requires the instrument to either irrevocably convert into ordinary shares of the registered bank (or parent entity of the registered bank) or irrevocably be written off on a capital trigger event or on occurrence of a non-viability trigger event (refer Subparts 2E and 2F of BS2B). Similarly, Tier 2 capital must also be capable of conversion into ordinary shares of the registered bank (or parent bank) or written off, but only on occurrence of a non-viability trigger event (refer Subpart 2F of BS2B).

The tax consequences on conversion of a regulatory capital instrument are important because of the so-called “regulatory haircut” that arises with respect to regulatory capital recognition under the RBNZ Framework. More specifically, BS2B stipulates that:

“In determining the value of an instrument for the purposes of regulatory capital recognition, the face value of an instrument must be reduced by any potential tax or other offsets that may reduce the amount of Common Equity Tier 1 capital generated for the registered bank as the result of conversion or write-off. Adjustments must be updated over time to reflect the best estimate of the potential tax and offset value. Potential tax liabilities should be based on the contractually intended mechanism, rather than the potential write-off ...”

It is for this reason that a conversion scenario is highly preferable to a write-off scenario. Given the tax complexity of a debt instrument that also contain an equity element (via the conversion requirement) and the importance to banks of recognising the full regulatory value of a regulatory capital instrument (i.e. not incurring the regulatory haircut), binding rulings are obtained to confirm tax treatments. Binding rulings are also a requirement of the RBNZ (refer “Application Requirements for Capital Recognition or Repayment and Notification Requirements in Respect of Capital” (**BS16**) – paragraph 18 and 19).

In order to qualify as regulatory capital, a registered bank must first obtain a non-objection notice from the RBNZ. Further, a bank cannot redeem/ repay bank regulatory capital unless it has received prior written approval from the RBNZ. This approval includes that:

“... prior to or concurrent with the repayment, the instrument is replaced with a paid-up capital instrument of the same or better quality and the terms and conditions of the replacement instrument are sustainable for the income capacity of the banking group. However, a replacement instrument is not required where the bank can demonstrate to the Reserve Bank’s satisfaction that the banking group’s capital position would be sufficiently above the minimum capital requirements after the repayment.” (refer paragraph 22 of BS16 and BS2B).



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A member of the
Commonwealth Bank
of Australia Group

11 November 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner
Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

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

SUBMISSION ON THE ADDRESSING HYBRID MISMATCH ARRANGEMENTS GOVERNMENT DISCUSSION DOCUMENT

ASB Bank Limited (ASB) is writing to submit on the "*Addressing Hybrid Mismatch Arrangements Government Discussion Document*" (the discussion document).

ASB appreciates having the opportunity to provide feedback to the Inland Revenue Department ("IRD") on the discussion document. We are happy to engage further with IRD officials to discuss our feedback.

As an introductory comment, we support the general direction of the OECD in tackling various global tax concerns through the base erosion and profit shifting ("BEPS") initiatives. However, we do recommend caution in the pace and format in which New Zealand adopts these BEPS initiatives. In the case of the hybrid mismatch proposals which are the subject of the discussion document, the proposals are extremely complex. This complexity will be increased further in situations where New Zealand has adopted these rules and key trading partners have not, and in situations where the application of our rules differs materially from regimes adopted overseas.

Our following comments address the potential impact that the discussion document proposals will have on bank regulatory capital.

1. Submission Point 5H

There are a number of issues with providing no exclusion for bank regulatory capital. We believe that bank regulatory capital instruments should be removed from the scope of the hybrid mismatch proposals.

In the Australasian banking sector, this is critical because a number of the New Zealand major banks are owned by the Australian major banks. Under both the regulatory capital rules imposed by the Australian Prudential Regulation Authority ("APRA") and

those of the Reserve Bank of New Zealand (“RBNZ”), regulatory capital instruments issued by a New Zealand branch or subsidiary may have dual recognition in both jurisdictions (ie, recognition as capital for the New Zealand branch or subsidiary as regulated by the RBNZ, as well as recognition as capital for the consolidated banking group regulated by APRA). Similarly, under the tax rules in Australia and New Zealand, they may have tax consequences in both jurisdictions.

As an example of the kinds of bank regulatory capital issues that may be affected, Additional Tier 1 Capital (“AT1”) instruments issued by a New Zealand branch of an Australian parent bank are more likely to result in cross border mismatches, due to the interaction of the banking regulators’ requirements for the form of AT1 capital and the application of Australia’s debt equity classification rules for tax purposes. The hybrid form of these instruments is driven by regulatory capital requirements, designed to help absorb the impact of any banking stresses and thereby protect depositors. The tax mismatch outcomes are essentially a result of Australia’s complex tax rules. Unless certain very restrictive criteria can be satisfied under Australian tax rules, a New Zealand branch of an Australian bank, issuing AT1 capital, has no choice but to attach franking credits to payments made under these instruments.

In our view, regulatory capital falls into a very different category of transaction to financial instruments designed to produce a certain tax outcome, for reasons that include the following:

1. The terms of the instruments are driven by regulatory requirements and not tax avoidance; this has been confirmed in both the Australian High Court in *Mills v Commissioner of Taxation* and through a number of binding rulings issued by the Inland Revenue Department in respect of these transactions.
2. The instruments are also raising funds for deployment in New Zealand
3. The instruments are publicly issued, and are not related party or structured arrangements designed to produce a certain tax outcome.

In relation to the New Zealand tax impact of AT1 instruments issued by a New Zealand branch of an Australian bank which are frankable, it is important to note that, as a commercial matter, the New Zealand branch then negotiates with investors to ensure that the value of the franking credits in the investors’ hands is recognised. This prevents the New Zealand branch from “over-compensating” the investors. Specifically, the terms of the instruments provide that the return can be paid wholly in cash or partly in franking credits. Where a return is paid in franking credits, this reduces the cash payment and therefore the deduction claimed in New Zealand. Eliminating the ability to pay the coupons partly in franking credits will increase the cash payments and hence the interest deductions in New Zealand. Australian investors themselves are indifferent to the receipt of franking credits or cash as this generally does not impact their after tax return.

Franking credits represent actual tax paid in Australia and are available to the company to attach to shareholder distributions; there is no requirement in Australia, or under New Zealand’s equivalent imputation regime, to attach credits only to cash derived from transactions that were themselves subject to tax. For example, an amount derived as a

non-taxable capital transaction can be paid out to New Zealand shareholders as an imputed dividend. The rules operate on a pooled basis rather than requiring tracing.

Disallowing these credits, or denying a deduction in New Zealand for franked distributions, runs counter to these pooling principles.

Specific submissions:

1. We question whether it is in New Zealand's best interests to introduce rules impacting bank regulatory capital that may increase interest deductions claimed in New Zealand.
2. The pool of funding available in New Zealand to fund the AT1 requirements of New Zealand banks is limited. Placing impediments on the ability of New Zealand banks to raise capital overseas will likely increase the overall cost of capital in New Zealand and will come at the expense of higher borrowing costs for New Zealand customers.
3. The terms of these instruments are driven by regulatory capital requirements; and the obligation to attach franking credits is driven by Australian tax requirements. Regulatory capital requirements only apply to a narrow range of entities. We consider that these transactions do not pose the same concerns to tax bases as other more tax driven transactions and should be removed from the scope of the hybrid proposals.
4. Franking credits represent actual tax paid in Australia. Where franking credits are attached to hybrid distributions, this reduces the franking credits available to attach to other distributions and therefore gives rise to a real economic cost. The IRD discussion document acknowledges but discounts this; we consider this aspect is not given sufficient weight. The Australian banks generally have significantly high dividend payout ratios, therefore any so called timing advantage is likely to be short lived.
5. Other jurisdictions around the world have been actively looking at carving out regulatory capital from the implementation of anti-hybrid rules because the rules run contrary to other national policies which are aimed at increasing the capital strength of the banking system and therefore the strength of their economies.

2. Submission point 11E

We consider it essential that in the event the hybrid mismatch proposals enacted do not carve out bank regulatory capital instruments, there should be a grandparenting period in respect of existing bank regulatory instruments on issue.

Paragraph 11.20 of the discussion document suggests that the hybrid rules should apply to all payments made after the effective date of the new rules, on the basis that this date is sufficiently far away that taxpayers will have time to restructure existing arrangements to avoid adverse consequences. However, the deductible frankable AT1

instruments issued in NZ (totalling in excess of NZD5bn) are invariably long dated and often involve unrelated investors with no knowledge of any so called unintended tax benefits in how these instruments are taxed. On the contrary, these instruments are generally supported by binding rulings in Australia and New Zealand confirming the tax treatment in those jurisdictions. There is no commercial ability to restructure these instruments to avoid the application of the hybrid rules and the life of the instruments generally extends beyond the likely effective date of any hybrids mismatch legislation in New Zealand. Therefore, the rationale for not grandparenting does not apply to the AT1 instruments already issued.

As noted above, other jurisdictions around the world have been actively looking at carving out regulatory capital from the implementation of anti-hybrid rules. Even following the issue of the OECD Final Report on Neutralising the Effects of Hybrids Mismatch Arrangements (“the OECD Final Report”), in late 2015, there has been no certainty that regulatory capital would be included in the scope of any hybrid mismatch rules implemented in New Zealand and Australia. The IRD had not made any public announcements of the exact scope of any intended changes prior to the release of the discussion document. We believe grandparenting should apply to all instruments on issue prior to the release of the IRD discussion document.

If the AT1 cross border instruments are not grandparented, there is a high likelihood that many of these instruments would need to be terminated and refinanced. The market reality is that if there are a large number of refinancing instruments going into the market at more or less the same time, the funding is likely to be expensive where available, and difficult to source. This would place strain on the banking sector, impacting funding costs and potentially the ability to write new business or meet existing funding ratio requirements. The effective recall of existing instruments on issue would also affect investor confidence in issues of this type, which is of significant concern given the importance of these instruments in achieving prudential banking requirements.

The AT1 instruments that are on issue in New Zealand will generally reach economic maturity within 5 years of any likely effective date. Lending decisions will have been made in reliance on this funding. It would be consistent with the approach taken in respect of the upcoming changes to onshore and offshore branch NRWT treatment, to allow existing instruments that are already on issue to be grandparented for a period of up to 5 years, to allow these instruments to mature without disrupting the market and the loan pricing decisions already made.

There are a number of reasons why New Zealand should seek to align with Australia on the timing of introduction of hybrid rules, the content of the rules and the timing and content of grandparenting provisions.

The nature of the hybrid proposals is that if Australia does apply Recommendation 2.1 of the OECD Final Report, but grandparents the existing deductible frankable AT1 instruments for a period and New Zealand does not, the primary rule would then apply to disallow the deduction in New Zealand. This would frustrate the intent of the Australian grandparenting and likely result in the need to terminate existing issues, which is very undesirable for the reasons discussed above.

If New Zealand is not at least aligned with Australia on the timing of introduction of hybrid rules, then New Zealand taxpayers will face significant compliance costs having to work through the varying implications that may arise over time due to that misalignment. This could give rise to several different tax treatments arising over the life of an instrument.

Specific Submissions:

1. Given the difficulty and complexity of unwinding AT1 instruments, existing AT1 instruments on issue at the date that the IRD discussion document was released should be grandfathered from the application of any anti-hybrid rules introduced in New Zealand.
2. Given the long lived nature of AT1 instruments, we submit that the grandfathering should apply for a period of at least 5 years from the date of application of any hybrid mismatch rules.
3. Wherever possible, New Zealand should strive to align content of the rules and application dates including grandfathering dates with Australia.

We also recommend that there is further detailed consultation on the content of any draft legislation before these proposals reach the stage of formally being introduced to Parliament in a Bill. The devil will very much be in the detail and it is critical that the legislation does not overreach and only captures the arrangements intended.

If you would like further details we would be happy to discuss the points raised in this submission. My contact details are ^{9(2)(a)} [REDACTED] or adrian.michael@asb.co.nz.

Yours faithfully



Adrian Michael
General Manager, ASB Taxation





11 November 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir

Addressing Hybrid Mismatch Arrangements

Dear Sir

We refer to *Addressing hybrid mismatch arrangements: A Government discussion document* ("the Document"), which was released for consultation on 6 September 2016. We appreciate the opportunity to comment and do so below.

1. Insurance Australia Group Business

Insurance Australia Group Limited ("IAG") is an Australian resident company operating in Australia, New Zealand, and Asia. IAG is the leading general insurance provider in New Zealand across both the direct and intermediated channels. Insurance products are sold directly to customers predominantly under the State and AMI brands, and through intermediaries (insurance brokers and authorised representatives) predominantly under the Lumley and NZI brands.

2. Executive Summary

IAG supports the aims of the New Zealand government in addressing hybrid mismatches. Our submissions address aspects of the proposals which would negatively impact our New Zealand business model, rather than commenting on the entire package. We submit that:

- With regard to frankable/deductible structures in general, the New Zealand government should not deny an interest deduction. As such structures are not tax exempt in Australia, a hybrid mismatch is not generated
- Should our primary submission be declined, the government should exempt regulatory capital from the scope of any measures to address hybrid mismatches, given its commercial importance
- In the event that each of these submissions are declined, the government should grandparent existing instruments from the impact of the proposals, and
- Regardless of the government's views on the submissions above, any measures affecting taxation of insurance industry capital should be deferred given the current changeable regulatory and tax situation worldwide.

3. IAG's issue of Reset Exchangeable Securities

IAG's interests centre on the application of the proposals to regulatory capital for insurers. The New Zealand branch of IAG Finance (New Zealand) Limited, a wholly owned subsidiary of IAG, has issued perpetual reset exchangeable notes, known as

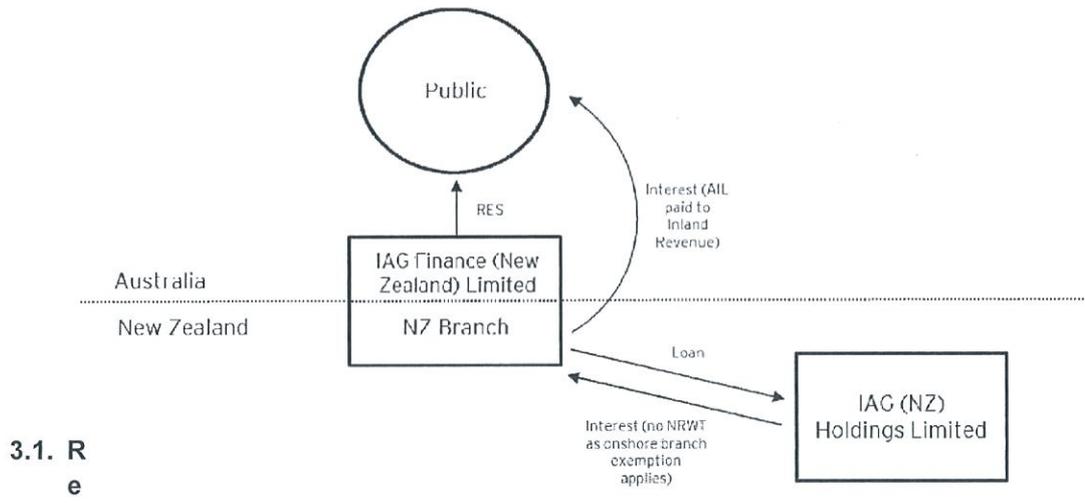
Reset Exchangeable Securities (“RES”) to external investors. The \$550 million funds raised have been loaned to IAG (NZ) Holdings Limited to fund IAG’s New Zealand operations. The RES are used to raise funds and enhance IAG’s capital structure by providing certainty of access to regulatory Tier 1 Capital if needed.

The RES may be exchanged by IAG or the holder on a reset date, or upon certain events. The next reset date is 16 December 2019. On exchange, IAG may convert RES into IAG preference shares, arrange a third party to acquire RES for their face value or redeem RES for their face value (subject to Australian Prudential Regulation Authority [“APRA”] approval).

The RES instrument, in its 2004 original form and its 2009 amended form, has been a key component of the IAG capital structure for 12 years. Since 2009, it has qualified as innovative Tier 1 capital and upper Tier 2 capital.

These arrangements are summarised in Figure 1.

Figure 1: IAG Finance (New Zealand) Limited existing funding arrangements



**3.1. R
e**

ation to proposals in the document

At paragraph 2.14, the Document refers to “*frankable/deductible instruments issued by the New Zealand branch of some Australian banks to the Australian public*”. The RES broadly follows the tax treatment explained in that paragraph. Although issued to third parties and listed on the ASX, it appears likely that the RES would fall within the definition of “structured arrangement” summarised at paragraph 12.5, and therefore fall within the scope of the document’s proposals.

The RES are regulatory capital, with IAG under the supervision of APRA. At paragraph 5.60, the document states that government does not propose to exclude regulatory capital from the implementation of hybrid mismatch rules.

4. Treatment of frankable/deductible instruments

We submit that New Zealand should not enact legislation to deny a deduction for amounts paid under deductible/frankable instruments such as the RES on the grounds that there is no hybrid mismatch against which action can be justified.

IAG does not agree with the assertion that “*there is no practical distinction between exemption and full imputation*”.¹ Amounts paid to RES investors are fully taxed in the investors’ hands and in no way exempt. The franking credits attached represent

¹ See para 5.5, at page 32.

underlying Australian tax paid and are therefore no longer available to be attached to other profit distributions. The instrument does not produce a deduction no inclusion ("D/NI") result.

While we appreciate that that the Document's analysis of frankable/deductible instruments is consistent with that in the OECD's report², that analysis is flawed. As New Zealand and Australia are the only two closely integrated economies with imputation systems, there is no need here to seek to follow international norms: decisions taken by the New Zealand and Australian government regarding imputation will be the international norm.

5. Exempting hybrid regulatory capital from hybrid proposals

Submission point 5H specifically requests comments regarding regulatory capital. IAG submits that in the event of our primary submission regarding frankable/deductible structures being declined:

- A specific definition of insurance regulatory capital is introduced. That definition could be closely linked to the regulatory rules set by the parent company regulator, in this case, APRA, and
- Insurance regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

We wish to make several points in support of our submission.

5.1. Efficiency of commercial insurance operations

Stringent rules could negatively impact the efficiency of commercial insurance operations. This will be due to the increase in the cost of capital without the present deductions. It may make New Zealand a less attractive destination with negative implications for the availability and price of insurance coverage. As a net capital importer this should be a major concern for any New Zealand government.

5.2. Commercial use of branches within insurance sector

The document implicitly assumes that the use of branches has limited, if any, commercial rationale. However, for many commercial, regulatory and operational reasons, insurers commonly operate internationally through branches. Rather than dispersing regulatory capital around a series of local subsidiaries, a "hub and branch" structure allows groups to free up capital and use it more flexibly by holding and managing it centrally. This approach is particularly common within the European Union and branches also play a part in the New Zealand market. The higher capitalisation possible through a hub and branch structure can give greater risk protection. It also gives access to lighter handed regulation and greater flexibility in doing business.

5.3. Importance of regulatory hybrid capital within insurance sector

Unlike most other industry groups, insurers face regulatory requirements to hold loss-absorbent capital as a proportion of their balance sheet size and risk. These requirements increase insurers' ability to deal with periods of high claims and reduce harmful effects for the wider economy.

Regulatory hybrid capital instruments have been popular within the insurance industry for around 15 years. Hybrid securities are considered an attractive, cost-efficient means of raising funds without diluting shareholders' rights. Forming an integral part of the regulatory capital of insurers such as IAG, instruments such as

²See Example 2.1 at page 280, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (OECD, October 2015)

the RES have certain equity-like features relating to loss absorbency and interest deferral which are mandated by regulators such as APRA. These equity-like features are mandated by regulation, are not designed to give a tax mismatch and are essential in supporting the insurance industry.

Following the global financial crisis, the degree of regulation has increased, with enhanced capital requirements and greater transparency. Regulators continue to see hybrid capital as having a valuable function, rather than attempting to close down the opportunity to issue such capital. Although the regulatory environment remains subject to reform, IAG is concerned that New Zealand tax officials are seeking to substitute their judgment of the merits of such capital to that of the regulator concerned.

5.4. Regulatory capital and BEPS

The Document does not explain how the payment of interest on regulatory capital enables BEPS. The purpose of regulatory capital is to reduce risks associated with leverage, rather than to increase it. In those circumstances, it appears counterintuitive to apply rules designed to counteract “excessive” leverage to regulatory capital.

Given this there is little risk of regulatory capital for insurers giving rise to BEPS issues and, accordingly, regulatory capital that conforms to the requirements of the particular regulator should be outside the scope of these proposals. The amount of capital that a particular entity requires is determined by the regulatory regime to which it is subject, the responsible regulator in IAG’s case being APRA. The terms of regulatory capital securities that lead to hybridity are consistent with regulatory requirements. Likewise, there are restrictions on how much of IAG’s minimum capital requirements can be made up of the different tiers of capital. The precise percentages applicable to IAG are the subject of discussion with APRA.

Regulatory oversight therefore provides an objective measure of how much additional Tier 1 and Tier 2 capital IAG may need. We note that the United Kingdom, which has consulted widely on issues associated with regulatory capital, has determined that anti-hybrid measures concerning regulatory capital are not required.

5.5. Tax outcomes for regulatory capital

IAG is concerned that even though structures, such as the RES mentioned above, were not implemented with tax avoidance in mind, the government’s proposals would result in payments by the New Zealand branch of IAG Finance (New Zealand) Limited being denied tax deductions in New Zealand.

The denial of tax deductions or imposition of tax charges could lead to unfair results for IAG and other insurers. Our cost of capital would increase, making New Zealand a less attractive place for inbound insurance and reinsurance business. This outcome appears contrary to the overarching goal for New Zealand’s tax system of maximising the welfare of New Zealanders, in part by ensuring that taxes from inbound investment are as fair and efficient as possible and that New Zealand remains an attractive place to invest and base a business, and by minimising distortions so that investments are financed in ways that are most efficient and undertaken by those who can do so most efficiently.³ In particular, the Document lacks any analysis of whether the policy considerations behind requirements for better capitalised financial services institutions outweigh any perceived BEPS risk.

³As set out in New Zealand’s taxation framework for inbound investment: A draft overview of current tax policy settings (June 2016), pp 3-4.

While commercial in nature, the RES have been designed with an expectation that the interest payments made by IAG are tax deductible. A tax deduction is necessary for the RES to provide a lower after-tax cost of capital for IAG. In effect, switching off the tax deduction is likely to make the RES an inefficient form of capital and, over time, remove investment opportunities and weaken capital markets in Australasia.

5.6. Consideration in overseas jurisdictions

Many jurisdictions have made conscious policy decisions to ensure that deductions are available in respect of coupons paid on Additional Tier 1 and Tier 2 capital instruments. This is the case within the European Union, where the majority of Member States have put in place rules which provide for payments under these types of instruments to be deductible, and elsewhere. It is not obvious to IAG that there is a need to harmonise conscious tax policy choices that individual countries have made in relation to regulatory capital and the application of anti-hybrid recommendations in respect of that capital.

6. Effective date for introduction of new rules

Submission point 11E requests comments on whether there are any special circumstances that would warrant departing from the general proposition of no grandparenting.

IAG submits that, in the event that our preceding submissions regarding frankable/deductible structure and insurance regulatory capital are rejected; then existing arrangements, in particular the RES, should be fully grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting period should be the absolute minimum requirement.

6.1. Analysis in document does not consider structured arrangements

One of the crucial statements concerning the Document's discussion of effective date are inconsistent with IAG's circumstances. The Document assumes that the rules will "*generally apply to arrangements between related parties or within a control group*"⁴, whereas the RES are issued to third parties and listed on the ASX. The RES will only be subject to the proposals because of the intended broad definition of structured arrangement.⁵

The Document goes on to state that the result should not generally be punitive, rather involving the loss of an unintended tax benefit. As we have submitted above, in IAG's case, the RES does not lead to a tax benefit or D/NI outcome.

Finally, the Document also states that the impact of the proposals will in most case be able to be established now, by reference to the OECD's Final Report. We consider that any assumption that OECD recommendations should be deemed to represent New Zealand law on complex, large, economically significant transactions, in advance of any government decisions on the matters in question to be an abuse of due process. Decision regarding New Zealand law should be made by Parliament, not asserted through discussion documents.

6.2. Inability to quickly unwind existing structure

The RES are a perpetual instrument held by third parties, with the next reset date not being until December 2019. Holders have chosen to invest based on current law and the RES have been costed on that basis. It would be prohibitively

⁴ See paragraph 11.20 to 11.22 at page 78.

⁵ See paragraph 12.5 to 12.7 at pages 80-81.

expensive to seek to unwind the structure before that date as investors have a legitimate expectation of a particular return until that date.

If more targeted rules are not applied there should be a considerable grandparenting provision or a period during which restructuring of hybrids can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise. This is consistent with the proposed application of non-resident withholding tax or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill.⁶ We also note that transitional arrangements proposed for measures in connection with employee share schemes will extend until 2022.⁷ The financial impact of unwinding instruments such as the RES far outweighs that of changes to employee share schemes.

7. Changeable current regulatory and taxation environment for insurers

Finally, we submit that the current regulatory and taxation environment for insurers is sufficiently changeable that all New Zealand tax measures affecting the treatment of regulatory insurance capital should be deferred. We make this point regardless of the government's decisions on our points above.

7.1. Insurance prudential regulation is evolving

The insurance industry is subject to global economic factors such as weak economic growth, low inflation rates, volatile financial markets and near-zero interest rates.

Internationally, we are seeing unprecedented levels of interaction among various insurance regulators—with a strong push for global standards in a broad range of areas from capital requirements to risk management. The International Association of Insurance Supervisors (IAIS) is now developing the first-ever global capital standards for large insurance groups that are active in multiple jurisdictions. The International Capital Standard is intended to be a truly global group measure unlike any current regulatory practice.

While the development of global capital standards will be a significant hurdle, IAG suspects that there will be many changes for the insurance industry in the next few years. Standards are likely to continue to evolve, rather than face a single point of change. Capital standards will interact across jurisdictions and with other aspects of regulation, with unknown results. There will be change at both a local and global level.

In New Zealand, for example, the Reserve Bank is planning a review of the Insurance (Prudential Supervision) Act 2010 (IPSA).⁸ IPSA provides the comprehensive framework for the prudential regulation and supervision of insurers

⁶ See clauses 5(4)(a), 5(4)(b) and 5(6) of the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill, which cover lending from a third party with a New Zealand branch, a foreign parent with a New Zealand branch and bank wholesale funding respectively. We consider these situations to be a much closer parallel to the RES than other parts of the non-resident withholding tax anti-deferral package referred to by the Document.

⁷ See Tax treatment of employee share schemes – further consultation (September 2016), paragraph 38 at page 13.

⁸ Terms of reference for the review can be viewed at <http://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/insurers/regulation/Terms-of-reference.pdf?la=en>

in New Zealand. The Reserve Bank plans to publish an issues paper in late 2016. We consider that it makes sense to assess any proposals to change IPSA before seeking to make tax changes affecting regulatory capital for the industry.

7.2. Tax treatment of insurance industry globally remains uncertain

The tax environment for insurers is currently, if anything, less certain than the regulatory requirements. In addition to the proposals in this Document, insurers may also be subject to restrictions on interest deductibility through BEPS Action 4. In this regard, the OECD has noted that *“Further work would be conducted in 2016 to identify appropriate approaches to address BEPS risks in these entities, taking into account the risks posed, the role interest plays in banking and insurance businesses, and restrictions already imposed by capital regulation. In particular it was noted that any approaches adopted should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis.”*⁹ Such work has not yet been completed, with the OECD currently considering public comments received regarding Action 4.

In IAG’s view, it is important to examine all changes which will affect insurer’s regulatory capital as a whole, rather than to separate reforms under BEPS Action 2 (as proposed in this Document) and pending reforms under BEPS Action 4.

IAG has yet to see other countries take action in isolation regarding regulatory hybrid capital. The Australian approach to date has been measured and represents an example which could be followed by New Zealand. The Australian Board of Taxation has reported that implementing changes to frankable/deductible hybrid regulatory capital structures *“would require a holistic review of Australia’s tax treatment of regulatory capital, encompassing potential changes to section 215-10 and the franking streaming rules.”*¹⁰ The Board sought, and was granted, further time to consider:

- the complexities and interactions involved
- the limited time period in which this review was able to be undertaken, and
- the need to undertake a holistic review to assess and ensure unintended consequences do not arise.

We understand that the Board’s report has been further delayed beyond its extended deadline of July 2016.

8. Conclusion

We would be keen to discuss the points raised in this submission in more detail. Please contact Craig Hespe 9(2)(a) in the first instance.

Yours faithfully



Craig Hespe
Head of Group Taxation

⁹ See BEPS Action 4 Approaches to address BEPS involving interest in the banking and insurance sectors (OECD, 28 July 2016) at page 5.

¹⁰ See Implementation of the OECD Hybrid Mismatch Rules: A Report to the Treasurer (The Board of Taxation, March 2016) at page 9.

Submission

to the

Inland Revenue Department

on

Addressing Hybrid Mismatch Arrangements: A Government Discussion Document

11 November 2016

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.
2. The following fifteen registered banks in New Zealand are members of NZBA:
 - ANZ Bank New Zealand Limited
 - ASB Bank Limited
 - Bank of China (NZ) Limited
 - Bank of New Zealand
 - Bank of Tokyo-Mitsubishi, UFJ
 - Citibank, N.A.
 - The Co-operative Bank Limited
 - Heartland Bank Limited
 - The Hongkong and Shanghai Banking Corporation Limited
 - JPMorgan Chase Bank, N.A.
 - Kiwibank Limited
 - Rabobank New Zealand Limited
 - SBS Bank
 - TSB Bank Limited
 - Westpac New Zealand Limited.

Background

3. NZBA welcomes the opportunity to provide feedback to the Inland Revenue Department (**IRD**) on “Addressing Hybrid Mismatch Arrangements: A Government Discussion Document” (**Discussion Document**).
4. NZBA welcomes the opportunity to discuss any of our feedback directly with IRD officials and, as outlined in our feedback, we recommend ongoing discussions with IRD Officials on this topic as the proposals develop. In this regard, please contact:

Philip Leath
Chair of NZBA Tax Working Group
GM, Tax – ANZ
04 436 6493 / 021 280 4717

General Comments

5. As a general comment, NZBA supports the ongoing work of the OECD to address valid concerns over base erosion and profit shifting (**BEPS**). As is highlighted by the OECD, implementation of the OECD’s BEPS recommendations should be co-ordinated on a multilateral approach. In the case of the anti-hybrid mismatch proposals, it will be important that New Zealand and Australia are aligned. In addition, given the complexity of the anti-hybrid mismatch proposals, it will be critical that any rules are clear and certain, particularly from a bank regulatory capital perspective to ensure certainty for investors, banks and the New Zealand banking system (including prudential regulators).

Submissions

6. NZBA outlines below key submission points in respect of the potential outcomes from the anti-hybrid mismatch proposal on bank regulatory capital. Our submissions focus on some of the specific questions raised in the Discussion Document and also provides general comments.
 - a. NZBA submits that there should be exclusion of bank regulatory capital from the anti-hybrid mismatch proposals (submission point 5H in the Discussion Document). RBNZ and APRA require Additional Tier 1 and Tier 2 capital to contain loss absorbency measures on the occurrence of certain stress events by either a conversion trigger into ordinary shares of the registered (or parent) bank or for the capital to be written off¹. The purpose of the loss absorbency measures is to absorb or protect against the impact of bank stresses and protect depositors. It is these, and other, regulatory conversion requirements that create an equity, and therefore hybrid element for such bank regulatory capital. In the case of the so called “frankable/deductible” bank regulatory capital, it is the combination of this regulatory conversion requirement and the Australian tax debt/ equity classification that results in the distributions being considered equity in Australia, upon which franking credits must be attached due to the streaming requirements of the Australian tax rules. The fact that the franking credits are not generated from the investments of the funds raised by the issue should not be relevant. If it were relevant, the natural concomitant would be to allow streaming of franking credits or, in New Zealand’s case, imputation credits – however, this is contrary to long standing New Zealand tax policy.
 - b. If our submission that there should be an exclusion for bank regulatory capital is not accepted, NZBA submits that existing bank regulatory capital issuances should be grand-parented (submission point 11E in the Discussion Document). We consider such grand-parenting should apply for all bank regulatory capital issued prior to the date of enactment of the enabling legislation or, at the earliest, from the date of release of the Discussion Document. We note that significant global uncertainty remains over whether bank regulatory capital should be excluded from anti-hybrid proposals. The OECD final report, “Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report”, drew no firm conclusion on bank regulatory capital and recommended each country adopt its own approach on this topic. Australia has not yet concluded how it will approach bank regulatory capital as part of their proposed anti-hybrid mismatch proposals, despite considering this topic for considerable time (and, as we submit below, New Zealand should harmonise its approach on bank regulatory capital to any approach Australia adopts). In further support of this submission, we note that:
 - i. Any potentially impacted bank regulatory capital will require multiple regulators’ approvals to restructure (where any request for such approval would, most likely, not be possible until legislation is enacted or, at least, substantively certain). It will also be important to ensure market liquidity exists for possible restructures, particularly as the potentially impacted bank regulatory capital issuances are held by the public and not related parties (contrary to what appears to be the inference from paragraph 11.20 of the Discussion Document). As such, it is preferable that bank regulatory capital

¹ As a write-off of bank regulatory capital results in a reduction to the regulatory value of an instrument (due to the tax liability that arises upon a write-off), the write-off option is economically undesirable (refer paragraphs 2.47 and 2.60 of RBNZ’s Capital Adequacy Framework (Internal Models based Approach) – BS2B).

is grand-parented or, at least, a significant lead-in time is provided for any restructure of bank regulatory capital.

- ii. It is not possible to restructure bank regulatory capital with a different instrument to “avoid any adverse consequences” from the anti-hybrid mismatch proposals (as paragraph 11.20 of the Discussion Document suggests). This is because banks are required to hold regulatory capital and it is the regulatory requirements that create the hybrid element.
 - iii. Further, given the limited liquidity of available investors for bank regulatory capital, it would be highly risky to seek to restructure the existing issuances to be held by, say, different investors (i.e. other than Australian investors). This would particularly be the case if all banks were required to restructure at similar times. Any such restructure may undermine the very purpose of the regulatory capital regime – to safeguard the New Zealand banking system.
- c. If our submission on grand-parenting is not accepted, NZBA submits that any proposals to apply the anti-hybrid mismatch proposals to bank regulatory capital should align, in both design and implementation dates, to the final position Australia adopts on bank regulatory capital in respect of their anti-hybrid approach. Harmonising the New Zealand approach to that of Australia would align to the OECD’s recommendation of taking a co-ordinated multi-lateral approach and minimise any additional market and regulatory disruptions that could arise if a different approach or timeframe were implemented. Harmonisation would be particularly important if Australia excludes bank regulatory capital from their anti-hybrid mismatch proposals (for example if they amend their rules to treat distributions on Additional Tier 1 capital as deductible) to ensure consistency across the trans-Tasman banking industry and regulators.
- d. NZBA recommends extensive consultation occurs on any further development of the anti-hybrid mismatch proposals, importantly before legislation is drafted, and that any draft legislation/ exposure draft is made available to interested parties for comment prior to introduction to Parliament as a Bill. This is particularly relevant for bank regulatory capital issued to the public which contains terms and conditions that are dependent upon the precise wording of tax legislation. We would be very happy to set up working group meetings with appropriate representatives from members of the NZBA in this regard.

11 November 2016

PARTNERS

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**SUBMISSION: ADDRESSING HYBRID MISMATCH ARRANGEMENTS -
 DISCUSSION DOCUMENT DATED SEPTEMBER 2016**

1. INTRODUCTION

1.1 This letter contains Russell McVeagh's submissions on the Government discussion document *Addressing hybrid mismatch arrangements* ("**Discussion Document**"). The Discussion Document seeks comments on how New Zealand should implement proposals set out in the OECD report *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* ("**OECD Report**"). We would be happy to discuss these submissions with Inland Revenue and Treasury officials if required.

1.2 References to "Recommendations" in this letter are references to the recommendations as set out in the OECD Report.

1.3 In summary, our submissions are:

General comments

Process and timing

- (a) The OECD recommendations are complex and cut across a number of existing domestic tax regimes and a broad range of transactions. It is critical that New Zealand does not rush any decision to implement the proposals.
- (b) Given the interdependent nature of the proposals, New Zealand should wait until it is known how and when other countries (and in particular Australia) will adopt the recommendations.
- (c) If New Zealand does decide to adopt some or all of the OECD recommendations, exposure draft legislation should be released for consultation prior to the introduction of legislation to Parliament.

Grandfathering and general exclusions

- (d) There should be grandfathering for existing arrangements. The proposed effective date (the beginning of a taxpayer's first accounting period after enactment of legislation) does not provide sufficient time for taxpayers to determine the likely impact of the rules and restructure existing arrangements.
- (e) There should be an exclusion for bank regulatory capital, given that banking regulations effectively require banks to issue hybrid instruments for regulatory purposes. If not, bank regulatory capital should be included in any grandfathering provisions (per submission (d) above).

Regulation-making power

- (f) We support the proposal (at paragraphs 11.18 and 11.19 of the Discussion Document) to permit the use of regulations to expand upon the detail of certain recommendations.

Recommendation 1 (Financial instruments)

- (g) Implementation of the proposals in the Discussion Document will further inhibit the ability of New Zealand taxpayers to enter into securities lending transactions. If implemented, the hybrid mismatch rules should be drafted with a view to not discouraging these transactions with third parties.

Recommendation 5.2 (Limiting the tax transparency for non-resident investors)

- (h) Recommendation 5.2 does not (contrary to Inland Revenue's suggestion) require New Zealand to tax the foreign-sourced trustee income of a New Zealand foreign trust to the extent it is not taxed in any other country. The fact New Zealand does not tax such income reflects the fact the income does not have a New Zealand source. It is not the result of a hybrid mismatch of the type with which the OECD Report is concerned.
- (i) Inland Revenue's other proposals in respect of Recommendation 5.2 would significantly cut across existing domestic tax regimes and the scope of any such changes will need to be clearly set out and analysed before any decision to adopt them is made.

Recommendation 6 (Deductible hybrid payments rule)

- (j) The proposal to apply the deductible hybrid payments rule to foreign branches of New Zealand companies would have wide-reaching consequences for arrangements which would not normally be considered "hybrids". If introduced, they should be accompanied by an active income exemption as proposed.

Recommendation 7 (Dual resident payer rule)

- (k) Dual resident taxpayers should be denied a deduction in one jurisdiction only. To deny a deduction in both jurisdictions is punitive. Inland Revenue's assertion that "dual residence status is in most cases deliberate rather than accidental" does not reflect reality.

Recommendation 10 (Definition of structured arrangement)

- (l) The definition of "structured arrangement" as described in the Discussion Document is overly broad, and would suggest that any transaction that on its terms gave rise to a hybrid mismatch would be a "structured arrangement". Any definition of "structured arrangement" in New Zealand should be more targeted, and should more closely reflect the policy object of the OECD Report.
- (m) Recommendation 10.3 provides for an express exclusion from the definition of "structured arrangement" for taxpayers and any member of the same control group that could not reasonably have been aware of the hybrid mismatch and did not share in the value of the tax benefit. This exclusion should be included in any definition of "structured arrangement" adopted by New Zealand.

2. GENERAL COMMENTS

Process and timing

- 2.1 The OECD recommendations are complex and cut across a number of existing domestic tax regimes and a broad range of transactions. The proposals are not limited to specific classes of hybrid transaction, but are proposed to extend (for example) to limit the tax transparency of New Zealand limited partnerships with foreign limited partners (Recommendation 5.2), or to deny deductions for losses incurred by a New Zealand company with a foreign branch (Recommendation 6). New Zealand should not rush the implementation of such changes.
- 2.2 The need for caution is exacerbated by the fact that the impact of the proposals on New Zealand is dependent on the way in which the proposals are adopted in other countries (particularly Australia). For example, whether New Zealand is required (under the primary rule in Recommendation 1) to deny a deduction for a payment that is treated as interest in New Zealand but as a dividend in Australia may depend on:
 - (a) whether Australia adopts the specific recommendation (in Recommendation 2) to deny the benefit of franking credits on dividends which are deductible in the payer jurisdiction; and
 - (b) whether the Australian rule is yet in force at the relevant time.
- 2.3 Given New Zealand's size, it is unlikely that other countries (including Australia) will change the manner or timing of *their* implementation of the OECD recommendations to reflect any decisions made by New Zealand. New Zealand accordingly should not be the "first mover", but should wait

until it is known with certainty how and when other countries will adopt the recommendations.

Exposure draft legislation (Submission Point 11D)

- 2.4 If and when New Zealand does decide to adopt some or all of the OECD recommendations, exposure draft legislation should be released for public consultation prior to the Bill being introduced to Parliament. This is critical to enabling meaningful analysis of how the proposals may apply in practice and whether any unintended consequences may arise.
- 2.5 It is also critical to allow sufficient opportunity to address technical drafting issues. Given the complexity of the proposed changes, it would be unrealistic to expect that all drafting issues could be addressed at the Select Committee stage.
- 2.6 For example, the imported mismatch rule contained in Recommendation 8 will require the implementation of a number of tracing and priority rules in order to establish the requisite nexus between a hybrid deduction made by one taxpayer and an imported mismatch deduction made by another. These rules may (in order to address the complex interaction of New Zealand's rules with rules in other jurisdictions) need to be highly detailed. The level of complexity will in turn inform the workability of Recommendation 8 in the New Zealand context, and therefore whether it should be adopted by New Zealand.

Grandfathering (Submission Point 11E)

- 2.7 The proposed rules should not apply to arrangements entered into prior to the introduction of the Bill to Parliament containing New Zealand's legislative response to the OECD Report, for a number of reasons:
- (a) First, the Discussion Document represents the Government's conceptual overview of the changes that may be introduced. A page titled "How we develop tax policy" on the Inland Revenue tax policy website describes the application of New Zealand's Generic Tax Policy Process. It states the role that discussion documents play in this process:

Again, discussion documents, or 'white' papers in this case, may be used for purposes of consultation. Proposed reforms may be revised in light of the submissions received. This phase culminates in Government approval of practical tax policy initiatives that are ready to be introduced into Parliament and implemented.

That is, a discussion document does not and should not reflect the Government's finalised policy choices in respect of an issue. Rather, a discussion document is the start of a process for the Government to make in principle decisions about future reforms. Only following consultation on the Discussion Document and decisions by the Government on how it will proceed (in the form of a Bill introduced to Parliament or, at a minimum, an exposure draft of such a Bill) should taxpayers be required to assume that the law

will likely change when deciding whether to enter into a significant commercial transaction.

- (b) Second, it should not be assumed that all existing transactions to which the proposals would apply are driven by tax rather than commercial considerations. The proposals in the Discussion Document would (as noted above) apply to a broad range of commercial arrangements. The tax treatment of such arrangements should not lightly be altered after they have been entered into.
- (c) Third, Inland Revenue overestimates the significance of the fact that some (but not all) of the recommendations are limited to related parties and structured arrangements. Even in the case of transactions with related parties, there can still be third parties with significant interests in the arrangements which may not have any incentive to agree to restructuring of the arrangement if the burden of any increased tax liability falls on another party.

2.8 If (contrary to our above submission) the rules do apply to existing arrangements, then at a minimum:

- (a) the proposed effective date for existing arrangements (the beginning of a taxpayer's first accounting period after enactment of legislation) should be extended to be a fixed date, one or more years after the enactment of any amending legislation; and/or
- (b) there should be an exclusion or grandfathering for specific categories of existing arrangements (such as regulatory capital, as described below).

Exclusion for regulatory capital (Submission Point 5H)

2.9 The Discussion Document indicates (at page 1) that "the OECD recommendations are targeted at deliberate exploitation of hybrid mismatches". In contrast, regulatory capital instruments meet regulatory requirements (administered in New Zealand by the Reserve Bank of New Zealand ("**RBNZ**")) for banks to maintain capital. The terms of such instruments are prescribed by the RBNZ. Regulatory capital instruments do not amount to what the Discussion Document describes as "deliberate exploitation of hybrid mismatches" and are therefore outside the mischief identified in the Discussion Document.

2.10 Given the importance of financial institutions being appropriately capitalised and properly regulated,¹ regulatory capital instruments should be excluded from New Zealand's implementation of the OECD recommendations. The OECD Report (at page 11) states that countries "remain free in their policy choices as to whether the hybrid mismatch rules should be apply to

¹ The OECD public discussion draft *BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* released in March 2014 ("**OECD Discussion Draft**") recognised (at paragraph 158) the "widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated".

mismatches that arise under intra-group hybrid regulatory capital".² Accordingly, New Zealand would be acting consistently with OECD recommendations were it to exclude regulatory capital instruments from its hybrid mismatch rules.

- 2.11 If regulatory capital instruments are not excluded from the implementation of hybrid mismatch rules in New Zealand, these instruments should receive the benefit of grandfathering in line with our submissions above. For the reasons set out above, grandfathering should apply to regulatory capital instruments issued before the date of introduction of any Bill to implement the OECD recommendations and/or Discussion Document proposals.
- 2.12 Grandfathering is particularly appropriate in the case of regulatory capital instruments. The main justification offered in the Discussion Document for no grandfathering is that the "rules generally apply to arrangements between related parties or within a control group [such that] restructuring arrangements should not be as difficult as it might otherwise be" (at paragraph 11.20). This justification is not applicable to regulatory capital instruments however.
- 2.13 First, in many cases, regulatory capital instruments are held by third party investors. Any redemption (even if possible) would affect third parties, which typically include retail investors. Second, to qualify as a regulatory capital instrument the terms of the instrument must require the issuer to receive prior written approval of the Reserve Bank of New Zealand to make any repayment of principal prior to maturity.
- 2.14 If regulatory capital instruments are not the subject of an exclusion or grandfathering, existing instruments would likely need to be refinanced. Given that multiple banks would likely need to refinance at the same time, it may be difficult to refinance all of the affected instruments.

Regulation-making power (Submission Point 11D)

- 2.15 If and when New Zealand does decide to adopt some or all of the OECD recommendations, we support the proposal (at paragraphs 11.18 and 11.19 of the Discussion Document) to permit the use of regulations to expand upon the detail of certain recommendations. A regulation-making power could also be used to manage the implementation of any hybrid mismatch rules in phases by only subjecting classes of financial instrument or entities to the hybrid mismatch rules as the impact of the rules have been fully considered.
- 2.16 Such regulation-making power would need to be subject to procedural safeguards to ensure that the regulations are not inconsistent with the primary legislation and are workable in practice. For example, it would be essential that exposure draft regulations be consulted on before being promulgated.

² The reference to "intra-group hybrid regulatory capital" reflects the assumption in the OECD Discussion Draft (at paragraph 160) that regulatory capital issued to third party investors would be "unlikely to be caught" by hybrid mismatch rules.

3. OECD RECOMMENDATION 1 (FINANCIAL INSTRUMENTS)

- 3.1 Securities lending transactions between third parties are commonplace and generally not tax driven. Their prevalence has been recognised by the fact that New Zealand and many other countries have enacted tax rules specifically to facilitate such transactions.
- 3.2 The Discussion Document does not adequately address whether such transactions are within the scope of the Discussion Document proposals. Without a clear rule excluding such transactions, implementation of the proposals in the Discussion Document will further inhibit the ability of New Zealand taxpayers to enter into securities lending transactions. We submit that securities lending transactions with third parties should be excluded from the implementation of the hybrid mismatch rules.

4. OECD RECOMMENDATION 5.2 (LIMITING TAX TRANSPARENCY OF NZ ENTITIES WITH NON-RESIDENT INVESTORS) (SUBMISSION POINT 7D)

Foreign trusts

- 4.1 Recommendation 5.2 does not (contrary to Inland Revenue's suggestion at paragraph 7.29 of the Discussion Document) require New Zealand to tax the foreign-sourced trustee income of a New Zealand foreign trust to the extent it is not taxed in any other country. The fact New Zealand does not tax such income reflects the fact that the income does not have a New Zealand source. It is not the result of a hybrid mismatch of the type with which the OECD Report is concerned.
- 4.2 This is supported by comments made in the report arising from the Government Inquiry into Foreign Trust Disclosure Rules (June 2016) ("**Shewan Report**"), at paragraphs 4.15 and 4.17:

The reforms were based on the core principle of taxing New Zealand residents on their worldwide income **and non-residents on income sourced from New Zealand. It follows from this principle that non-residents should not be taxed on non-New Zealand sourced income.** This was, and remains, orthodox international tax policy.

[...]

The Consultative Committee that recommended the settlor regime in 1988 **specifically recognised that one consequence of this approach would be that New Zealand would not tax the foreign source income of a resident who was the trustee of a trust with a non-resident settlor.** The Committee noted-

In our view, this is the appropriate treatment since such income has no definite connection with New Zealand apart from the existence here of the trust administrator ... who will ... have no beneficial interest in the income.

[Emphasis added]

- 4.3 Inland Revenue's suggestion (at paragraph 7.29 of the Discussion Document) is also inconsistent with one of the conclusions of the Shewan Report, which was summarised at paragraphs 13.27 and 13.28 of the Shewan Report:

The Inquiry concludes in Part 4 of the report that the current tax treatment of foreign trusts, **including the exemption from tax on foreign source income, is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy.** A repeal of the tax exemption, or other legislative changes aimed at closing the foreign trust industry down, would not be justified on policy grounds unless it was concluded that other options could not deal adequately with any problems identified.

The Inquiry considers that, if adopted by the Government, the changes recommended to the disclosure rules will deal adequately with the problems identified, including reputational risk. **It does not recommend the repeal of the tax exemption** or other changes aimed at preventing the operation of foreign trusts in New Zealand.

[Emphasis added]

- 4.4 The Shewan Report was an inquiry conducted this year that was specifically aimed at the foreign trust regime whose recommendations were adopted by the Government. If New Zealand were to now look to implement recommendation 5.2 in a manner inconsistent with the Shewan Report, it would suggest an incohesive and ad hoc approach to the formulation of tax policy, which could undermine confidence in New Zealand as a place to do business.
- 4.5 For New Zealand to tax non-New Zealand sourced income that is earned from capital settled by non-New Zealand settlors and that is not distributed to New Zealand resident beneficiaries would amount to taxation based on the formalistic criterion of a trustee (who's role is to administer and not benefit from the assets of the trust) being resident in New Zealand. Taxation by reference to such a formalistic criterion hardly seems consistent with the general philosophy underlying the OECD's BEPS initiatives.

Scope of other proposals

- 4.6 Inland Revenue's other proposals in respect of Recommendation 5.2 would significantly cut across existing domestic tax regimes and the scope of any such changes will need to be clearly set out and analysed before any decision to adopt them is made.
- 4.7 For example, in respect of the proposal to tax payments made to New Zealand look through entities (such as a limited partnership) that have some non-resident investors, it is not clear whether it is intended that the limited partnership ceases to be transparent entirely for New Zealand tax purposes, or whether New Zealand would tax only the income "attributable" to the foreign limited partners. In either case, there are likely to be a number of practical issues to work through (for example, the consequences of a disposal by a non-resident partner to a New Zealand resident partner, or vice versa).

5. OECD RECOMMENDATION 6: DEDUCTIBLE HYBRID PAYMENTS (SUBMISSION POINT 8)

- 5.1 The proposal to apply the deductible hybrid payments rule to foreign branches of New Zealand companies would have wide-reaching consequences for arrangements which would not normally be considered "hybrids". Indeed, a New Zealand business expanding overseas for the first time, operating through a branch in (say) Australia, could find itself subject to anti-hybrid rules intended to address "the deliberate exploitation of hybrid mismatches".
- 5.2 In particular, the proposal to apply the deductible hybrid payments rule to a foreign branch would restrict the ability for deductions to be claimed in respect of the foreign branch while the foreign branch is in a loss position. It will not be uncommon for New Zealand businesses seeking to expand internationally to be, at least initially, in a loss position in respect of their foreign operations. Any change that makes it more difficult for businesses to utilise such losses should be approached with caution.
- 5.3 The Discussion Document does propose certain measures to ameliorate the effects of, or to limit, the potential denial of deductions. In particular, the Discussion Document contemplates that:
- (a) a foreign branch's loss could be deductible in New Zealand if it can be shown that the losses cannot be used to offset non dual-inclusion income in the branch country;
 - (b) a non-deductible loss could be carried forward;
 - (c) an active income exemption could be introduced.
- 5.4 However, none of these solutions is perfect, and each can be expected to increase tax costs (for example, the risk of stranded losses where losses are carried forward), or compliance costs, for New Zealand businesses seeking to expand overseas.
- 5.5 If the decision is made to adopt Recommendation 6 and apply the hybrid payments rule to branches, then each of the measures set out at paragraph 5.3 above, including the active income exemption, should be adopted.

6. OECD RECOMMENDATION 7: DUAL-RESIDENT PAYERS (SUBMISSION POINT 9A)

- 6.1 Dual resident taxpayers should be denied a deduction in one jurisdiction only. To deny a deduction in both jurisdictions is punitive. We do not accept Inland Revenue's assertion that "dual residence status is in most cases deliberate rather than accidental" (Discussion Document, paragraph 9.3).
- 6.2 The assertion that dual residence status is most often deliberate rather than accidental is unsubstantiated and, in our view, unlikely to be correct. The four bases of residence for companies mean that there are a number of ways in which a company can become resident in New Zealand. Some of these are not clear cut, and it is entirely possible for a company to become

resident accidentally (for example, if it is incorporated in one country, but for commercial reasons has some executives or directors located in another).

- 6.3 The recommendation to deny a deduction for such entities in both jurisdictions seems to follow from the assumption that these entities have made a deliberate choice to be dual resident, and is effectively punitive. We submit that a better approach would be to deny a deduction in only one of the jurisdictions.

7. OECD RECOMMENDATION 10: DEFINITION OF STRUCTURED ARRANGEMENT (SUBMISSION POINT 12)

- 7.1 The definition of "structured arrangement" is an important definition in the context of the Discussion Document proposals. In most cases the proposals will not apply to transactions with third parties unless the transaction is a "structured arrangement". Consequently, it is critical that the definition of "structured arrangement" is clearly defined. An ill-defined or unduly expansive definition of "structured arrangement" will result in the hybrid mismatch rules potentially applying to transactions outside the intended scope of the OECD Report.

- 7.2 The Discussion Document proposes to define a structured arrangement as one where either (paragraph 12.7 of the Discussion Document):

- (a) the hybrid mismatch is priced into the terms of the arrangement; or
- (b) the arrangement has a purpose or effect of producing a hybrid mismatch.

- 7.3 In the context of section BG 1, Inland Revenue's Interpretation Statement IS 13/01 provides (at paragraph 192):

The purpose or effect of an arrangement, including any tax avoidance purpose or effect, is determined objectively. The taxpayer's intentions are not relevant. "Purpose", in the context of tax avoidance, means the intended effect the arrangement seeks to achieve and not the motive of the parties. "Effect" means the end accomplished or achieved by the arrangement. ...

- 7.4 A "purpose or effect" test, as contained in the second bullet point of paragraph 12.7 of the Discussion Document, would suggest that any transaction that on its terms gave rise to a hybrid mismatch would be a "structured arrangement". The "structured arrangement" criterion would therefore add nothing. Every arrangement that gives rise to a hybrid mismatch would be a structured arrangement. This would expand the scope of New Zealand's hybrid mismatch rules radically beyond the scope of the OECD Report recommendations which are intended to be limited to structured arrangements (and/or arrangements between related persons).

- 7.5 For completeness, we note that the Discussion Document does not discuss (or indicate inclusion in any domestic law definition) Recommendation 10.3. Recommendation 10.3 excludes a taxpayer from the definition of structured arrangement where neither the taxpayer nor any member of the same control group could reasonably have been expected to be aware of the

hybrid mismatch and did not share in the tax benefit resulting from the mismatch. This specific exclusion should be included in any domestic definition of "structured arrangement".

Yours faithfully
RUSSELL McVEAGH



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Addressing hybrid mismatch arrangements
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue
PO Box 2198
Wellington 6140

Sent by email: policy.webmaster@ird.govt.nz

11 November 2016

Addressing hybrid mismatch arrangements

Dear Sir/Madam

We appreciate the opportunity to comment on the Government discussion document *Addressing hybrid mismatch arrangements* released 6 September 2016.

Submissions

In addition to our initial submission comment in this paragraph, we set out below five other submission points which we believe the Commissioner should consider in the interest of providing clarity to a wide range of taxpayers.

- 1. We have kept the submission points deliberately high level as one of our key overall submission points and concern is that a lot more detail around the design and outline of the legislative provisions is needed. Once provided, we will be in a position to give proper consideration to the design of the wide ranging and multi faceted proposals which impact many areas of the tax legislation.*
- 2. New Zealand should not be one of the first wave of “early adopters” and should not implement the hybrid mismatch arrangement rules prior to a reasonable proportion of OECD countries enacting the rules.*

It is our view that, at a minimum, the timing of implementation should be coordinated with other OECD jurisdictions to ensure New Zealand is not in the first wave and, if necessary, deferred until the majority of countries with a New Zealand taxation connection, such as those with capital funding into New Zealand, have implemented the anti-hybrid rules. We consider there to be little advantage for New Zealand being an early adopter and effectively acting to close down tax mismatches that are usually caused by the specific tax rules in other countries rather than in New Zealand.

The discussion document references rules to come into effect in the UK and Australia. Our understanding is that the implementation of such rules in Australia is likely to be behind the timetable referenced in the discussion document, and draft legislation has not yet been worked on in any detail. We also consider it likely that the legislation actually enacted in a number of countries will be

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materially watered down or countries will have other features in their overall tax regimes so that they remain internationally attractive to multinational groups. We consider it very prudent for New Zealand to watch and observe and ensure that the tax rules that we enact in New Zealand do not end up disadvantaging New Zealand from an overall international competitive perspective compared to the tax rules that actually end up being implemented in our major trading partners.

The successful implementation of the OECD recommendations regarding hybrid mismatch arrangements released in late 2015 are hinged on the precondition that most countries will adopt the rules. The United States has indicated they will not adopt the OECD recommendations and despite the “expectation that countries that are part of the consensus will act”, there is no guarantee whether, or confirmation when, these other countries will take real action and introduce significant law changes.

Advancing with the implementation of these rules, based only on the presumption that the rest of the world will match these actions and in a pure and consistent way based on the OECD recommendations, exposes New Zealand taxpayers to substantially increased costs of tax compliance and administration without the guarantee of reciprocity made in counterparty jurisdictions. New Zealand should not place itself in a position to be the “world tax police”, left responsible for monitoring cross-border transactions to ensure that the correct amount of tax is collected globally. The tax base of New Zealand may not be significantly benefited where taxpayers restructure such arrangements prior to the introduction of these rules – for example, replacing interest deductions arising from a hybrid financial instrument with interest deductions arising on a “vanilla” debt instrument. Rather, the focus needs to be refined so that consideration is also given to the overall competitiveness of New Zealand’s tax system in light of these proposals and accordingly the long term impact on the New Zealand economy.

We request that the Government and the Commissioner consider a more appropriate delayed timeframe for implementing any of these rules in New Zealand, with particular reference to the timing and implementation of the rules in other jurisdictions.

This is particularly true for the proposed imported mismatch rule. To the extent that such rules are determined to be required in New Zealand (which we doubt is really needed weighing up all the factors), at a minimum, New Zealand should phase in this complex tax burden following the introduction of the rules by our key trading partners. As noted by the Board of Taxation in the review of implementation of the imported mismatch rule in Australia, such rules would give rise to “considerable compliance challenges”, would be “difficult to administer”, and would place “unfair compliance burden on [Australian] entities”. In our view New Zealand should not implement the imported mismatch rule.

- 3. Targeted domestic tax rules to address specific concerns, such as the foreign dividend exemption provision, would be a more pragmatic option in the short term given the relative urgency expressed in the discussion document for the introduction of anti-hybrid rules*

The complexity of the proposed rules, as discussed further below and discussed with Inland Revenue Policy officials in several different forums over the last month or more, is indicative of how challenging the underlying objective ultimately is. We understand the political drivers behind the proposed changes (and we consider the political pressure to be seen to be acting at the head of the pack is dangerous and slightly naïve given New Zealand’s economic position as needing foreign investment to

continue to grow). Therefore, we urge that the detailed design of these rules not be rushed in New Zealand so that there is sufficient time to work through the intricacies and observe how a number of other countries actually implement the rules, to assess how they interact with the various regimes in the existing legislation and to allow for undue complexities to be reduced as much as possible.

Targeted and specific rules can more easily be isolated and examined so that each knock-on effect can be thoroughly, and responsibly, explored. The discussion document concedes in section 3.17 that “the New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown”. Additionally, the same section suggests that the tax revenue at stake in relation to funding arrangements comparable to the *Alesco* arrangement is approximately \$300 million. However, the *Alesco* case involved no loss of revenue, because if the purchase had been funded by ordinary interest bearing debt (rather than the hybrid, Optional Convertible Note) the same interest deductions would have been claimed by *Alesco* New Zealand. We urge that the overall benefit to New Zealand be carefully modelled to maintain the integrity of the New Zealand tax system. Further, these benefits should be weighed up against the cost of new rules to substantiate their introduction.

Further, we note that the majority of hybrid financing arrangements such as *Alesco* are a feature of the past given the dramatically changed tax risk environment in New Zealand in recent years. This needs to be factored in to ensure the complexity of the rules far outweighs the practical relevance in New Zealand going forward.

We request that the Commissioner delay the introduction of wide sweeping rules and instead prioritise certainty above all else. Alternatively, while awaiting the introduction of hybrid rules in overseas jurisdictions, targeted New Zealand tax rules could be implemented that capture a specific hybrid structure or instrument that has been identified by Inland Revenue as particularly concerning in a New Zealand context (such as the extension of the carve out to the foreign dividend exemption in CW 9 mentioned in the paper).

4. The current level of complexity of the proposed rules means they will be hugely difficult for taxpayers to interpret and comply with in practice

The theoretical benefit of the proposed rules is significantly impeded by their complexity. Taxpayers will have to go to extraordinary efforts and ongoing cost, not only to understand how the new rules will apply to their business, but also to acquire a detailed understanding of the tax law in each counterparty jurisdiction before the new rules can be correctly applied. We are concerned that the complex nature of the proposed rules will lead to increased compliance costs for both taxpayers and tax administrators.

For example, with regard to hybrid financial instruments, the rules require taxpayers to understand in the counterparty jurisdiction the ordinary tax treatment of a payment; whether a deduction would be denied or participation exemption switched off; and anticipate the future tax treatment of the payment to determine whether the mismatch is purely a timing difference. This is only one simplified timeline of events. There will inevitably be unforeseen complexities that disrupt this logical sequence. One example of an unforeseen complexity is where the New Zealand taxpayer denies a deduction in New Zealand after identifying a mismatch in the counterparty jurisdiction; at a later point in time the tax authority in the counterparty jurisdiction disputes the tax treatment of this income; the income is subsequently deemed to be taxable. The New Zealand taxpayer that has complied with the rules is left

disadvantaged unless the income tax return that corresponds to the denied deduction is reopened and corrected.

The proposed ability to carry forward disallowed deductions to offset against “dual inclusion income” (which in itself is a complex concept and will need careful drafting to be understandable) in future years is intended to benefit taxpayers by preventing double taxation but the discussion document does not consider how this will be achieved practically. It assumes New Zealand entities will have the ability and capacity to track disallowed deductions in New Zealand going forward together with the corresponding receipt in the counterparty jurisdiction. We support the fairness that this proposal is seeking to achieve, however we are concerned that the difficulty and increased compliance burden associated with tracking the treatment of two amounts in two different jurisdictions will ultimately result in double taxation.

We consider that making the hybrid mismatch rules sufficiently difficult so that businesses are encouraged to use simpler structures, which do not require the rules to be applied, is not an appropriate justification for their complexity. There are valid commercial reasons for establishing such structures and these should not need to be discarded in exchange for the possibility of eliminating mismatches. Given the complexity of the issue, the rules should not be designed solely with taxation outcomes in mind.

We request that the Commissioner make every effort to ensure future communication of the proposed rules is presented in a way that the practical impact can be better understood by taxpayers. Supporting guidance in a second round of consultation (before draft legislation going into a Tax Bill) in the form of detailed commentary and design of the provisions needed should be provided to assist taxpayers to navigate the proposed rules in a way that is not dependent on a high level of tax technical knowledge. The rules should be effective at disqualifying inappropriate advantages but not at the expense of the integrity of New Zealand’s tax system or New Zealand’s investment.

- 5. The implied ability of New Zealand taxpayers to access sufficient information to comply with the proposed rules is inconsistent with commercial and practical reality and does not contemplate the barriers that New Zealand taxpayers are likely to encounter in practice*

The discussion document comments in relation to accessing information that “[...] the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context.”

We strongly disagree with the assumption that a New Zealand member of a control group will be able to easily access information and we are concerned that otherwise compliant New Zealand taxpayers will be unable to proffer sufficient information to comply with the proposed rules. Often, New Zealand corporates are at the “bottom of the chain” and are materially insignificant relative to other members of wider corporate groups. In this inbound context, requests for information from New Zealand are unlikely to be prioritised by global tax managers or executive groups. It will be particularly difficult to communicate the sudden need for certain information from counterparties in jurisdictions that do not have equivalent hybrid rules in place.

We expect that this problem will only be exacerbated outside of a wholly owned group scenario. Joint ventures will also be classified as under common control under proposals (i.e. a 50% test) and is an

example of a situation where accessing information will not be a straight forward exercise. Others can be seen in the proposed CFC and FIF changes, which apply to “related entities”, i.e. a 25% test.

From a practitioner perspective, lack of available information is also a concern. The proposed rules as they stand assume ease of access to detailed information, which may not always be possible, particularly in other jurisdictions that have tighter disclosure restrictions and generally less information transparency. In providing New Zealand tax advice, practitioners would be required to understand how counterparty jurisdictions throughout the chain treat the concerned payment and supporting information will also be required to substantiate advice provided. In practice this type of information is often legally privileged and therefore inaccessible without the risk of losing such privilege. We consider the expectations that the proposed rules will put on New Zealand practitioners to be contradictory to what has been established as good practice; New Zealand tax advice should be based on New Zealand tax legislation.

We request the Commissioner clarify what extra information will be required to support positions taken when filing a New Zealand income tax return and address how such information will be collected (e.g. through the Exchange of Information Agreement), particularly where rules prohibit its disclosure.

6. Supplementary guidance and detail required before the full impact of each distinct rule can be adequately contemplated and to facilitate comprehensive discussion

The complexity of the rules and the sweeping application that they are intended to have justifies the need for an in-depth analysis to determine all resulting implications. We do not consider the current guidance, nor the timeframe provided, sufficient to allow complete comments to be provided on each of the upwards of 25 submission points. There are a number of issues that have been left open by the document with an ask for taxpayers and practitioners to comment on and we are concerned that each of these will not be given the careful consideration that they require. We consider Inland Revenue needs to do a lot more thinking on the design of the rules and key aspects of the proposed legislative rules and then ask for consultation and feedback again.

The discussion document also makes certain assumptions that should be considered further. For example, in considering dual resident entities, the paper states that dual resident entities arise as a result of tax planning. In our experience, this is generally not the case, and instead is more likely to arise through innocuous actions, where taxpayers have inadvertently relaxed governance procedures, resulting in dual resident status. Given the practical reality of such arrangements, the proposal to remove the Place of Effective Management test will likely put pressure on competent authorities, requiring significant additional resources for this work to be undertaken and significant time delays. Our view would be to retain the current tie breaker test.

Additionally, the discussion document does not appropriately address the interaction of the proposed hybrid rules with New Zealand’s existing tax rules. The impact on New Zealand’s withholding tax, thin capitalisation and transfer pricing regimes is noted only at a high level. The implications for these proposed changes should be further outlined for taxpayers’ consideration, and in particular, should ensure that a consistent approach is taken for the hybrid rules as are currently in our tax rules. For example, the tax outcome of the hybrid proposals for a hybrid instrument seek to “disallow deductions” claimed, effectively re-characterising the instrument as equity for tax purposes (similar to a section FA 2 debenture). However, it is proposed that interest withholding tax would still be payable

on the disallowed interest. We have major concerns with this. This can be contrasted with the thin capitalisation rules that acknowledge the interest deductions claimed but seek to deem interest income to arise to the New Zealand taxpayer where the safe harbour thresholds are exceeded, which seems much more rationale.

In relation to the transfer pricing implications of the proposed rules, other than the high level comments provided in paragraphs 11.5 and 11.6, we are uncertain how the rules would operate where the transfer pricing methodology used in the counterparty jurisdiction differs from that used in New Zealand. In practice, we are aware that interest rate pricing often varies between jurisdictions with different levels of “safe-harbours” and expectations with respect to the level of interest rate pricing analysis undertaken. Although there is no mismatch with regard to the treatment, clarification is required in relation to how the difference in the two “arms-length” amounts should be treated (i.e. is the New Zealand taxpayer required to include an additional income top-up to account for this difference?).

The Commissioner should provide additional guidance to support the proposed rules, once they have been more fully developed, and which considers the resulting implications of the fundamental shifts in practice that will need to take place to facilitate compliance with the rules.

General

We trust these high level comments are useful and we look forward to providing more detailed comments on a further round of consultation once more thinking and design and high level drafting of the different points are worked on by Inland Revenue and circulated for further comment and consideration.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Boyce', with a long horizontal flourish extending to the right.

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A handwritten signature in black ink, appearing to read 'fwilliams', written in a cursive style.

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Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
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11 November 2016

Email: policy.webmaster@ird.govt.nz

Dear Sir

Submissions on *Addressing hybrid mismatch arrangements* discussion document

We refer to the discussion document, *Addressing hybrid mismatch arrangements*, which was released for consultation on 6 September 2016 ("DD"). We appreciate the opportunity to comment and do so below and, in more detail, in the attached Appendices.

We do not see the proposals in the DD ("Hybrid Rules") as being suitable for enactment in their current form. Instead we recommend that New Zealand's overall approach is reconsidered. We have therefore taken a selective approach when choosing whether to respond to the specific questions posed for submission.

Given the complexity of the proposals, we suggest that a further consultation round with detailed draft legislation is carried out before final decisions are made - rushing legislation into a Bill in early 2017 would be premature.

Executive Summary

In terms of process:

- ▶ Before making any decisions regarding the proposals in the DD, the Government should explicitly assess the proposals against its published Revenue Strategy and also against the overarching goal for New Zealand's tax system of maximising the welfare of New Zealanders.
- ▶ New Zealand should not be an early adopter of anti-hybrids measures as international norms have yet to materialise.
- ▶ Consideration should be given to a less complex package of measures targeted at known problems rather than a wholesale importation of recommendations designed for tax systems and economies very different to New Zealand.
- ▶ Existing arrangements should be fully grandfathered from the hybrid proposals. Alternatively, a lengthy grandfathering period should be the absolute minimum requirement.

Our selective comments on the substance of the proposals should be read subject to our overall view that the proposals as a whole should not be enacted in their current form:

- ▶ New Zealand taxpayers, generally at the bottom of the chain for multinational enterprises, will find it difficult to obtain sufficient information to comply with the primary rule.

- ▶ All decisions in respect of branch structures, in particular whether there should be an active income exemption for foreign branches of New Zealand companies, should be deferred until the OECD has finalised its recommendations regarding branches.
- ▶ New Zealand should not enact legislation to deny a deduction for amounts paid under frankable/deductible instruments on the grounds that there is no hybrid mismatch against which such action can be justified.
- ▶ The use of imputation credits to reduce tax on a dividend which is deductible to the payer should not be denied.
- ▶ The primary rule should not apply to deny deduction where tax has been imposed in the hands of the payee's owners under a Controlled Foreign Company ("CFC") regime.
- ▶ Regulatory capital should be excluded from any hybrid rules.
- ▶ The commercial consequences of the proposals should be examined in more detail before final decisions are made.
- ▶ There should be some clarification around the existing concept of a "segment" of income for foreign tax credit purposes.
- ▶ The proposed rule to ignore imputation credits when applying the secondary rule to hybrid dividends should not proceed.
- ▶ Timing differences should not be subject to the Hybrid Rules. In the event that submission is rejected, then greater thought should be given to the merits of the United Kingdom test and/or to lengthening the period over which timing mismatches are acceptable to longer than three years.
- ▶ The transfer of assets should not be subject to the rules, therefore the question of an exemption for revenue account holders is not relevant.
- ▶ There should be an objective test which taxpayers can apply in assessing dual residence, e.g., place of effective management.

With regards to design principles, should the package proceed:

- ▶ Non-resident withholding tax ("NRWT") should not be charged on an interest payment for which deduction has been denied.
- ▶ The proposals should not be subject to the general anti-avoidance rule ("GAAR") due to the level of uncertainty this will cause.
- ▶ The proposals should be contained in primary legislation rather than subsidiary regulation.
- ▶ An amendment to the taxpayer secrecy provisions in s 81 of the Tax Administration Act 1994 will be required to enable Inland Revenue to release necessary information to counterparties.
- ▶ Inland Revenue needs to examine the interaction of the time bar provisions within s 108 of the Tax Administration Act 1994 with the proposals.

We would be happy to discuss any aspect of our submissions with you. Please contact David Snell (david.snell@nz.ey.com) in the first instance in that regard.

Yours faithfully

A handwritten signature in blue ink, appearing to read "Aaron Quintal". The signature is fluid and cursive, with the first name "Aaron" being more legible than the last name "Quintal".

Aaron Quintal
Partner - Tax Advisory Services
Ernst & Young Limited

Appendix A - Process

Need to address Action 2 of the OECD/G20 Base Erosion and Profit Shifting (“BEPS”) Action Plan

The Government has supported the OECD/G20 BEPS Action Plan. Given that support, we agree that the relevance of the Action 2 recommendations to New Zealand should be assessed. We agree with the Minister of Revenue who has stated:

“First, we need to ensure our own domestic tax laws are robust and consistent with international best practice. This is to ensure that our domestic tax settings protect our tax base and do not facilitate double non-taxation, tax avoidance or evasion.”¹

We also acknowledge:

- ▶ The immense challenge for any organisation or group of countries to design and achieve widespread acceptance and implementation of any set of income tax rules that will operate coherently and symmetrically between or among different jurisdictions.
- ▶ The various OECD/G20 BEPS Action Plans, as finalised in October 2015 contain numerous and ambitious proposals and recommendations to that end.
- ▶ New Zealand wants to be seen to be doing the right thing in terms of the international tax community.

Absence of clear framework for proposals

We submit that the Government should explicitly assess the proposals against its published Revenue Strategy² and also against the overarching goal for New Zealand’s tax system of maximising the welfare of New Zealanders.³

An enduring strength of New Zealand’s tax system has been its clear framework, with an emphasis on coherence, economic efficiency, equity, and ease of compliance and administration within a broad-base, low rate structure. The Government’s Revenue Strategy, reproduced in part below, reinforces those aims.

We have particular concerns that the proposals are not planned and coherent, may bias economic decisions and have high compliance and administration costs. It is not clear from the DD precisely how the wholesale implementation of all Action 2 recommendations is consistent with the Government’s Revenue Strategy. What does seem clear is that any such wholesale implementation will cut across many general principles and concepts in the framework of New Zealand’s domestic income tax system.

The only references to a framework in the document are to current problems with the “global international tax framework”. We accept that the proposals seek to minimise opportunities for tax avoidance and evasion, but they do so in an arbitrary manner and are in any event unlikely to succeed.

¹ *Base Erosion And Profit Shifting (BEPS) – Update on the New Zealand Work Programme*, Cabinet Paper, May 2016, paragraph 24.

² “The tax system should be as fair and efficient as possible in raising the revenue required to meet the Government’s needs. The Government supports a broad-base, low-rate tax system that minimises economic distortions.”

The Government considers these goals are best supported by a tax system that:

- maintains revenue flows to pay for valued public services and reduce debt
- responds to New Zealand’s medium-term needs in a planned and coherent way
- biases economic decisions as little as possible - which allows people to work, save, spend or invest in ways that they believe are best for them
- rewards effort and individuals’ investment in their own skills
- has low compliance costs and low administrative costs
- minimises opportunities for tax avoidance and evasion, and
- shares the tax burden as fairly as possible.”

See Government 2016 Revenue Strategy at <http://www.treasury.govt.nz/government/revenue/strategy>

³As set out in *New Zealand’s taxation framework for inbound investment: A draft overview of current tax policy settings* (June 2016), pp 3-4.

When making decisions on the merits of the proposals when compared to New Zealand's framework, we would like to highlight:

- ▶ The absence of consideration of the Government's intentions in terms of New Zealand's tax base, other countries' tax bases and the lack of a clear purpose for each specific proposed legislative measure. We do not favour additional legislation unless the case for it has been made.
- ▶ The denial of tax deductions or imposition of tax charges could increase the cost of capital in New Zealand. We could become a less attractive place for inbound investment. This outcome appears contrary to ensuring that taxes from inbound investment are as fair and efficient as possible and that New Zealand remains an attractive place to invest and base a business. It is inconsistent with the Minister of Finance's undertaking at the time of the OECD/G20 BEPS Action Plan Final Reports that:

"We need to always consider the effect that tax policy has on the productive sector of the economy. Decisions have to be made as to what extent the OECD recommendations are applicable to New Zealand and the best way to implement them, giving thought to matters such as compliance costs."⁴

- ▶ Selective denial of deductions is likely to increase distortions by effectively preventing investments from being financed in ways that are most efficient and undertaken by those who can do so most efficiently.
- ▶ New Zealand depends on inbound investment, with a degree of leverage inevitable. It is possible to argue that hybrid instruments are the means by which leverage is introduced in New Zealand, as opposed to the driver for that leverage. Implementation is therefore likely to lead to less efficient ways of introducing debt into New Zealand rather than to any material increase in the overall tax take.
- ▶ The proposals have a potentially negative impact on New Zealand's capital markets. The very existence of a set of rules designed to counter hybrid mismatch outcomes is likely to influence taxpayer behaviour so that, most obviously perhaps, New Zealand taxpayers will ensure their future borrowings from related parties are by way of straightforward loans.⁵ This is not necessarily a desirable outcome: there is an investor demand for high quality investment opportunities and for investments with a risk profile between that of debt and of equity. It is possible that the quality and range of investment opportunities in New Zealand will reduce.

How far should international co-operation drive implementation?

We submit that New Zealand should not be an early adopter of anti-hybrids measures as international norms have yet to materialise.

The OECD/G20 recommendations are not mandatory minimum standards which member countries are obliged to enact unchanged in full. New Zealand is permitted to amend our policy response to match our domestic and economic objectives.

With regard to our BEPS-related objectives, the Government has categorised these as being that all taxable income earned in New Zealand should have tax paid in New Zealand, all gross revenue earned in New Zealand should be identified and reported; and deductions from gross revenue should reflect the real economic costs of production, free of measures deliberately designed to reduce tax liability.⁶ The Government has previously stated that "*our approach is to be mindful of the tax system as a whole and to take a considered approach*".⁷

In substance, the Government's policy appears to be to support BEPS measures which help to ensure that multinationals pay the right amount of tax in New Zealand, but to follow rather than lead international norms. Government policy can best be served by learning from other countries and acting selectively. To date, however, only the United Kingdom, Australia and the European Union have put forward measures in

⁴ Media statement *OECD releases full BEPS action plan* by Minister of Finance and Minister of Revenue, 6 October 2015 <http://taxpolicy.ird.govt.nz/news/2015-10-06-finalised-beps-action-plan-released> (as accessed on 16 September 2016)

⁵ Introduction, page 1.

⁶ *Base Erosion and Profit Shifting (BEPS) – Update on the New Zealand Work Programme*, Cabinet Paper, May 2016, paragraphs 3 and 4.

⁷ Hon Todd McClay, former Minister of Revenue, Address to CAANZ Annual Conference, 19 November 2015.

respect of Action 2, with only the United Kingdom reaching the stage of enactment. Significant sources of inbound investment such as the United States, Singapore, Canada, China and Japan have yet to take any action, nor has any Asia-Pacific country outside Australia and New Zealand. Countries such as Germany have consciously deferred decisions. There are as yet no international norms.

New Zealand's unicameral system and stable government means that we are at real risk of leapfrogging almost all of our investment partners in enacting and implementing any Hybrid Rules. As New Zealand is not a major financial centre and few New Zealand businesses drive intra-group funding arrangements or group structuring decisions, early adoption makes little, if any, sense.

Approach is overly complex

We submit that a less complex package of measures targeted at known problems should be considered rather than a wholesale importation of recommendations designed for tax systems and economies very different to New Zealand.

Consistent with OECD recommendations, the proposals are complex. They encompass a set of primary and secondary rules and defensive responses, with different rules for each of the hybrid arrangements covered. This interlocking matrix seems more complicated than any domestic law regime of any country in place prior to the United Kingdom's adoption of anti-hybrid measures.

Moreover, it envisions the global adoption of rules that must then mesh across the two or more countries involved in any particular transaction or arrangement. It does not seem possible that all countries will adopt this framework consistently.

This means the proposals involve substantial uncertainty and significant risk of double taxation. There is also a significant overlap between the proposal on addressing hybrid mismatch arrangements and the Government's ongoing work on limiting interest deductibility under Action 4.

This degree of complexity is not needed for the New Zealand tax environment. New Zealand already has robust existing rules and Inland Revenue has a strong track record in winning disputes regarding hybrid arrangements.

We suggest that this complexity and overlap leads to:

- ▶ The need to consider a more selective, simpler approach targeting known problems rather than a catch-all approach with unknown effects.
- ▶ The desirability of putting forward the Hybrid Rules and interest limitation proposals as a single package so that their combined impact can be assessed and trade-offs made.
- ▶ A need to examine the interaction of the proposals with the terms of New Zealand's double tax agreements.

Effective date for introduction of new rules (Submission point 11E, page 78)

We submit that existing arrangements should be fully grandfathered from the hybrid proposals. Alternatively, a lengthy grandfathering period should be the absolute minimum requirement.

Investors have entered into hybrid mismatch arrangements on the basis of existing law, with such arrangements having been priced on that basis. To amend existing structures, in particular hybrid financial instruments, would be inefficient and may cause otherwise desirable inbound investment to cease. We are particularly concerned regarding the impact that a failure to grandparent current investments may have on the ability for New Zealand business to attract future inbound investment.

The DD states that “the rules generally apply to arrangements between related parties or within a control group”⁸, suggesting that restructuring may not be too difficult. This will not always be correct. Some hybrid financial instruments will be issued to third parties, widely held and listed on a recognised exchange. They will only be subject to the proposals because of the intended broad definition of structured arrangement.⁹

The DD goes on to state that the result should not generally be punitive, rather involving the loss of an unintended tax benefit. Given the wide scope of the proposals, it is not correct to state that the tax benefit is unintended – it can be a deliberate design feature within a country’s tax legislation.

We also note that unwinding a hybrid entity arrangement, particularly a structure involving limited partnership, can be challenging and potentially costly if not properly planned. In many cases, unwinding such structures may involve a significant legal entity restructure.

Finally, the DD also states that the impact of the proposals will in most case be able to be established now, by reference to the OECD/G20’s Final Report on Action 2 (“Action 2 Report”). We doubt that outcome is realistic, particularly in the many less obviously “hybrid” situations which we anticipate could fall within the extremely broad scope of all the Action 2 Report recommendations. We consider any assumption that OECD/G20 recommendations should be deemed to represent New Zealand law on complex, large, economically significant transactions, in advance of any government decisions on the matters in question, would be an abuse of due process. Decisions regarding New Zealand law should be made by Parliament, not asserted through discussion documents.

If more targeted rules are not applied there should be a considerable grandparenting provision or a period during which restructuring of hybrids can be undertaken. Grandparenting, or delayed application for a period of at least five years from enactment, would be a reasonable compromise. This is consistent with the proposed application of NRWT or the approved issuer levy for many of the branch lending proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill.¹⁰ We also note that transitional arrangements proposed for measures in connection with employee share schemes will extend until 2022.¹¹ The financial impact of unwinding complex hybrid instruments far outweighs that of changes to employee share schemes.

⁸ See paragraph 11.20 at page 78.

⁹ See paragraph 12.5 to 12.7 at pages 80-81.

¹⁰ See clauses 5(4)(a), 5(4)(b) and 5(6) of the Taxation (Annual Rates for 2016-17, Closely Held Companies and Remedial Matters) Bill, which cover lending from a third party with a New Zealand branch, a foreign parent with a New Zealand branch and bank wholesale funding respectively

¹¹ See *Tax treatment of employee share schemes – further consultation* (September 2016), paragraph 38 at page 13.

Appendix B - Substance of proposals

Difficulty in complying with primary rule

We submit that New Zealand taxpayers, generally at the bottom of the chain for multinational enterprises, will find it difficult to obtain sufficient information to comply with the primary rule.

The Action 2 Report proposes two-tier rules in a number of its recommendations. The primary rule is that the payer country would deny deductions. The secondary rule is that the payee country would include payments received in taxable income. Claiming deductions would depend on payers knowing or being able to ascertain that their payments would be fully taxable in recipients' jurisdictions.

We consider there are at least two substantial issues with such proposals:

- ▶ Possible difficulties and cost for payers in determining the treatment of their payments in recipients' jurisdictions, especially if they are required to consider the tax treatment (including treatment of any tax credits) of any possibly connected payments for any recipients beyond their direct and immediate payees or the controlled foreign company ("CFC") treatment of ultimate owners in overseas jurisdictions. Expecting New Zealand taxpayers to be able to provide proof of actual taxation of amounts under the CFC rules of overseas jurisdictions is unreasonable.

Differences between payer and payee countries, for example, in relation to treatment of leases and the treatment of foreign exchange variations would seem to make for additional complexity for New Zealand taxpayers who may have to isolate the amounts at risk from calculations ordinarily performed under New Zealand's domestic laws for financial arrangement accrual expenditure and leases. Differences in the timing of recognition between payer and payee countries would also seem to add to New Zealand taxpayers' tax compliance burdens.

Countries' domestic tax laws cannot be assumed to remain static. Accordingly it would not be sufficient for a payer to ascertain the recipient country tax treatment as a one-off matter. Rather, at least annual review and checking would be needed over the total period a possibly affected instrument, structure or arrangement is in force.

- ▶ Possible circularity of contingencies. The application of the primary rule depends on the recipient country's treatment, but the latter may depend on the deductibility or otherwise in the payer country. It does not seem clear which country's provisions should apply first if each country has provisions which apply if the item is treated in a particular way in the other country. New Zealand's s CW 9 provides an example in that it taxes foreign dividends derived by a New Zealand resident company from a non-resident company if they are deductible (directly or indirectly) overseas. What would happen, however, if the overseas deduction depended on whether or not the item was taxable or exempt in New Zealand?

These concerns may particularly impact merger and acquisition activity. Hybrid entities and instruments are a common feature of private equity structures, with a need to review structures to determine if they give rise to *deduction no inclusion* ("D/NI") outcomes.

However, the nature of international tax financing is that in many cases this will be extremely difficult. Taxing cross border financing is inherently complex and the means by which taxation (or deductibility) occurs is often nuanced and territory specific.

This will not be a one-off exercise. Changes required to domestic laws will likely be adopted at differing times, increasing uncertainty as to the level of value available from financing costs and bringing into focus the sustainability and durability of transaction structures.

Establishing a robust position for a New Zealand taxpayer will require a level of understanding around the foreign outcome. This burden becomes increasingly onerous where such an outcome occurs pursuant to detailed legislation, specific concessionary treatment or under principles not recognized in New Zealand law (such as taxation of chargeable gains).

Overreach of proposals

The Action 2 Report comments (paragraph 13) that the only types of mismatches targeted by its report are those that rely on a hybrid element to produce mismatches, such as differences between transparency and opacity of an entity for tax purposes or differences in the characterisation of instruments. It appears, however, that the potential scope of any changes may be much broader than those ordinarily seen as falling within those categories. Almost any difference in income tax treatment of any transaction between parties in different countries appears to be under attack.

Examples of areas where we have concern include:

Branches (Submission point 8, page 64)

We submit that New Zealand should defer any decisions in respect of branch structures, in particular whether there should be an active income exemption for foreign branches of New Zealand companies, until the OECD has finalised its recommendations regarding branches.

The tax treatment of branches, in particular the possibility of an exemption for active income earned through a foreign branch, is an important topic. It should be given separate consideration rather than be seen as a by-product of anti-hybrid measures. We also note:

- ▶ There is a lack of clarity in the DD regarding the treatment of New Zealand branches, which appear possibly to fall within the requirements to be a disregarded hybrid payment structure. The DD notes that *"no characteristics in and of themselves would qualify an entity as a hybrid payer"* and that *"an entity that is considered to be a hybrid payer in one scenario may not be a hybrid payer under a different scenario"*.¹²
- ▶ The DD was released shortly after the OECD released its Discussion Draft regarding branch mismatch structures. We are not clear on the extent to which the DD is intended as a response to these recent proposals, which should be fully considered before New Zealand makes any decisions regarding hybrids.
- ▶ Hybrid mismatch situations targeted by the Action 2 Report relate to the use of hybrid instruments and entities, whereby the use of such hybrid entity or instrument is frequently at the choice of the taxpayer. Such is not the case for branches. Whether certain activities constitute a permanent establishment is purely dependent on the threshold for recognising taxable presence in a country where a foreign taxpayer's business activities are conducted.

Frankable/deductible instruments

We submit that New Zealand should not enact legislation to deny a deduction for amounts paid under frankable/deductible instruments¹³ on the grounds that there is no hybrid mismatch against which such action can be justified.

The assertion that *"there is no practical distinction between exemption and full imputation"*¹⁴ is incorrect. Amounts paid to investors in frankable/deductible instruments are fully taxed in the investors' hands and in no way exempt. Any difference is one of timing only. The franking credits attached represent underlying Australian tax paid and are therefore no longer available to be attached to other profit distributions. The instrument does not produce a D/NI result.

¹² See paragraph 6.7 at page 47.

¹³ See paragraph 2.14 at page 11.

¹⁴ See paragraph 5.5. at page 32.

While we appreciate that that the DD's analysis of frankable/deductible instruments is consistent with that in the Action 2 Report¹⁵, that analysis is flawed. As New Zealand and Australia are the only two closely integrated economies with imputation systems, there can be no need here to seek to follow international norms: decisions taken by the New Zealand and Australian governments regarding imputation will be the international norm.

Paragraphs 2.14 and 2.15 of the DD describe examples of such instruments in the trans-Tasman context, referring, in particular, to the Australian case of *Mills v Commissioner of Taxation*¹⁶. That case concerned the ability of an Australian bank to frank distributions to mainly Australian investors on certain notes issued by the bank's New Zealand branch. If there is any problem in such situations, it arises from the Australian domestic characterisation of certain instruments for income tax purposes and in the Australian treatment of a company's overseas branch income, rather than from New Zealand's provisions and treatment.

For instruments such as the PERLS V instruments described in the *Mills* case, we suggest it is not altogether appropriate to focus on the deductible nature of the interest on the notes in New Zealand and the New Zealand branch's income not being taxable in Australia as a self-contained or isolated stream of income. Clearly the Australian bank (CBA) had to have had, or received, Australian-taxed income in order to have franking credits available. The interest payments from the New Zealand branch were also, presumably, taxed in New Zealand by means of NRWT or the Approved Issuer Levy ("AIL").

Denial of imputation credits (Submission point 5A, page 32)

We oppose the introduction of legislation to deny the use of imputation credits to reduce tax on a dividend which is deductible to the payer.

Paragraph 5.6 of the DD considers the related situation where a hybrid instrument is issued by the foreign branch of a New Zealand company. It acknowledges that Example 2.1 would not apply because New Zealand would tax the branch income, but then continues by saying "*there seems no reason not to amend legislation to deny the use of imputation credits to reduce tax on a dividend which is deductible to the payer.*" We oppose any proposal to introduce such a measure. Just because there does not seem to be any reason against doing something is not a valid or good enough reason to do that thing.

Taxation under other countries' CFC rules (paragraphs 5.26 - 5.27, page 36)

We submit that the primary rule should not apply to deny deduction where tax has been imposed in the hands of the payee's owners under a CFC regime.

The DD highlights, but does not express a view on the likely outcome, whether inclusion pursuant to a parent company's CFC rules should mean that the primary rule does not apply. Our view is that CFC inclusion higher up the chain should be treated as tax imposed in the same manner as if the hybrid arrangement were taxed in the direct counterparty.

Introducing an exemption where income is caught by a third territory's CFC rules would increase complexity. However, this complexity seems an unavoidable consequence of the removal of probable double taxation.

Regulatory capital (Submission point 5H, page 45)

We submit that New Zealand should exclude regulatory capital from any hybrid rules it implements.

Submission point 5H specifically requests comments regarding regulatory capital. There is little risk of regulatory capital for banks and insurers giving rise to BEPS issues and, accordingly, regulatory capital that conforms to the requirements of the particular regulator should be outside the scope of these proposals. The amount of capital that a particular entity requires is determined by the regulatory regime to which it is

¹⁵See Example 2.1 at page 280, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (OECD, October 2015)

¹⁶[2012] HCA 51

subject. The terms of regulatory capital securities that lead to hybridity follow regulatory requirements. Likewise, there are restrictions on how much of the minimum capital requirements can be made up of the different tiers of capital. The precise percentages applicable for a particular institution will be the subject of discussion between the regulator and the regulated entity. Regulatory oversight provides an objective measure of how much additional tier one and tier two capital a bank or insurer might be expected to need. We note that the United Kingdom, which has consulted widely on issues associated with regulatory capital, has not enacted restrictions in this area. The Australian Board of Taxation highlighted the complexities and interactions involved and recommended further work be undertaken on the issues. The Board has been granted an extension to examine this matter further, indicating that the matters involved are complex. Exemption could be achieved along the following lines:

- ▶ A specific definition of banking and insurance regulatory capital is introduced. That definition could be closely linked to the regulatory rules set by the parent company regulator, and
- ▶ Banking and insurance regulatory capital is excluded from the implementation of hybrid mismatch rules in New Zealand.

A further aspect relating to banks which requires more careful and detailed consideration given the current NRWT and Approved Issuer Levy proposals in the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill is the treatment of notional loans and payments between branches and cross-border head offices of the same legal entity and any disregarded payments rule (paragraphs 6.1 to 6.9 of the DD).

Commercial consequences of proposals

We submit that the commercial consequences of the proposals should be examined in more detail before final decisions are made.

The DD states that the proposals are not intended to disturb commercial or regulatory consequences.¹⁷ It falls short of meeting that aim. Without limiting the scope of the rules to situations whereby the hybrid mismatch is artificial or contrived, there is significant risk of scope creep. Hybrids implemented for non-tax reasons will be caught by these rules notwithstanding the motives behind their design and implementation. Alternatively, such structures may be designed to utilise benefits explicitly allowed under New Zealand tax law.

In addition to the frankable/deductible structures already discussed, we are concerned by the inclusion of New Zealand family trusts (presumably complying trusts) within the potential category of reverse hybrids, at paragraph 7.2. Presumably there must be a limit on when the Hybrid Rules potentially apply to distributions to non-residents from New Zealand resident family trusts? It is common for children to receive distributions from such trusts while they travel overseas. The “temporarily absent” five-year rule in s HC 23 specifically covers this eventuality. It is possible that the allocation of overseas income by the New Zealand trust to the non-resident beneficiary may trigger the Hybrid Rules - which cannot have been intended. The present trust account and record keeping rules do not require the trustee to enquire into the tax treatment of that overseas income in the hands of the non-resident beneficiary. In any case, most New Zealand resident trustees would not have the capacity to make meaningful tax enquiries.

The reverse hybrid rule could also apply to foreign investor Portfolio Investment Entities (“PIEs”), to the extent the PIE derives foreign-sourced income which is allocated to foreign investors. Application of the rules in this situation will lead to uncertainty.

We also have concerns for the case of United States-parented groups introducing leverage down the chain. For example, where the United States entity sits above a “check the box” entity based in a low tax jurisdiction which provides funds to a disregarded New Zealand company. A tax benefit may result due to the differential between the New Zealand tax rate and that of the low tax jurisdiction, but we had understood that the intent was not to address benefits attributable to differences in tax rate rather than to the hybrid structure adopted.

¹⁷ See paragraph 1.9 at page 7 and paragraph 4.6 at page 22.

Limits on foreign tax credits (Submission point 5A, page 32)

We submit that there should be some clarification around the existing concept of a “segment” of income for foreign tax credit purposes, to determine whether any further restriction is needed.

Paragraph 5.7 of the DD proposes amending the definition of a “segment” of foreign source income “so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign source income”.

Before any such amendment is introduced, we suggest there should be some clarification around the existing concept of a “segment” of income for foreign tax credit purposes, to determine whether any further restriction is needed at all.

Section LJ 4 defines the phrase “segment of foreign-sourced income” for Subpart LJ (foreign tax credit) purposes as “equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature”. We are uncertain of the meaning of “source” intended in this specific context, and of the intent of use of the alternative. For example, does it mean one can group interest payments from three different companies (sources) in the same country on the basis they are all income of one nature from the same country, or is it intended to treat interest payments from each company as a separate segment, on the basis they are from different sources (i.e., separate contractual instruments or arrangements)?

Proposal to tax intra-group dividends on hybrid financial instruments and ignore imputation credits attached (Submission point 5B, page 41)

We submit that the purpose of the proposed rule to ignore imputation credits when applying the secondary rule to hybrid dividends is unclear and that it should therefore not proceed.

Paragraphs 5.42 to 5.44 of the DD refer to situations set out in Example 1.23 of the Action 2 Report where New Zealand is Country B. The sort of situation envisaged would therefore appear to involve the New Zealand B Co 1 being an unlimited liability company which is treated by a US parent as a transparent entity under the US “check the box” rules. Presumably the loan from B Co 2 is legally a debt, in order for the US A Co to claim any interest deductions, although treated as equity under New Zealand’s income tax rules.

It is not clear what the DD proposal is seeking to achieve (beyond, possibly additional tax payable in New Zealand if the payments continue to be regarded as dividends under New Zealand law but dividends which cannot have imputation credits attached) or what the justification really is. In itself, the New Zealand proposal would not seem likely to produce any global benefit or modify global behaviour in any useful way unless Country A changes its domestic rules to make the interest deduction contingent on New Zealand taxing an equivalent amount.

Timing mismatches (Submission point 5C, page 42)

We submit that timing differences should not be subject to the Hybrid Rules. In the event that submission is rejected, then greater thought should be given to the merits of the United Kingdom test and/or to lengthening the period over which timing mismatches are acceptable to longer than three years.

We recommend that the rules are targeted at permanent rather than timing differences. Given the proposed continued application of withholding tax, even where deductions are denied, and the current proposed widening of NRWT and restriction of AIL, the complexity involved with a timing mismatch rule outweighs the tax at stake. The DD does not appear to have considered how any timing mismatch measures will interact with the NRWT changes which are currently in the process of being enacted. As initially drafted, we are aware those proposals have attracted a number of submissions and objections, and it is not yet known whether or how they will be resolved. The addition of another layer of rules, this time potentially limiting deductions, would provide another layer of complexity and further compliance burden.

To demonstrate that complexity, issues associated with seeking to deny deductions to the extent they are not matched with income recognition in another country in the same period, include the need:

- ▶ For detailed knowledge of other country’s income recognition rules.

- ▶ To obtain or hold confirmation or proof that the recipient has returned the income.
- ▶ To perform additional calculations to remove foreign exchange variation elements.
- ▶ To keep track of the fact and extent of any timing mismatches across a number of income years and from year to year.

In practice, should a timing mismatch rule be adopted, either the Australian three-year approach or the United Kingdom “reasonable period” approach are worth considering. The Australian approach is not automatically better. In some cases it will be more restrictive and will not reflect timing differences that arise under commercial arrangements. An example here may be a five-year finance lease with balloon repayment at the end of year five. For New Zealand, deductions would be spread under the financial arrangement rules but, in the United Kingdom, would be taxable at the end of year five under a specific statement of practice. Such an arrangement would likely lead to the denial of deductions under an Australian approach but cause no issues and remain deductible under the United Kingdom approach.

There also needs to be the ability to allow for correction of treatments as countries’ time frames for implementation of the hybrids recommendations will vary, with some countries unlikely to adopt any or very few of the proposals and others likely to defer adoption for some years.

Transfer of assets: revenue account holders (Submission point 5F, page 44)

We submit that the transfer of assets should not be subject to the rules, therefore the question of an exemption for revenue account holders is not relevant.

Submission point 5F asks whether there should be an exemption from the Hybrid Rules for revenue account holders.

We query why New Zealand should introduce any Hybrid Rule at all that applies to straightforward asset transfer transactions. Just because different countries may characterise and tax such transfers differently does not seem to justify treating them as hybrid mismatches for which specific anti-mismatch rules should apply. Asking about possible exemptions therefore begs the main point at issue.

Applying Hybrid Rules to such transactions would seem to cut across a fundamental New Zealand domestic principle that capital/non-taxable and revenue/taxable characterisations may apply differently to each party to a transaction. It would counteract the application of the financial arrangement rules when there is a cross-border element, but not when a transaction occurs between New Zealand residents.

Paragraphs 5.52 to 5.55 of the DD refer to a New Zealand taxpayer who purchases an item from a non-resident under an agreement for sale and purchase where our domestic financial arrangement rules require the purchaser to treat part of the consideration as financial arrangement expenditure rather than as part of the cost of the item. Paragraph 5.52 seems to assume the non-resident vendor is not taxable on any part of the sale proceeds on any basis.

Incorporating a Hybrid Rule into New Zealand’s law to reduce or prevent the purchaser from claiming any deduction, just because the vendor country’s domestic laws do not apply an identical financial arrangement accrual approach and do not tax capital amounts, seems to cut right across New Zealand’s general recognition that items can be acquired or disposed of on revenue account for one party while being held, sold or acquired as non-taxable, capital account items for the other transacting party. It is not clear why such differences should continue to be recognised in transactions between residents but not in cross-border transactions.

Paragraph 5.64 proposes that domestic transactions would be specifically excluded from application of the Hybrid Rules. As noted above, however, distinguishing between domestic and cross-border transactions would seem to introduce further inconsistencies and possible anomalies. We submit the real issue is whether or not there should be any Hybrid Rules relating to asset transfers.

Dual resident payers (Submission point 9A, page 67)

We submit that there should continue to be an objective test which taxpayers can apply in assessing dual residence under double tax agreements (“DTAs”), e.g., place of effective management.

Paragraph 4.33 of the DD refers to Chapter 13 of the Action 2 Report and a proposed change to Article 4(3) of the OECD Model Tax Convention. Under that change, dual residence issues for non-individual entities would be resolved on a case-by-case basis by the competent authorities of each DTA partner, rather than by taxpayers applying an objective and interpretative rule, such as the current place of effective management criterion.

Relying on competent authorities to determine residence under mutual agreement procedures on a case by case basis is not a satisfactory outcome. We doubt it would be practicable or cost-efficient for mutual agreement procedures to have to be invoked by any entity which may happen to be dual resident in terms of two countries’ domestic laws. We submit New Zealand should not agree to or adopt such an approach.

Much more detailed consideration is required before proceeding with any domestic law change to a general rule that an entity is not a resident of a state if it is considered to be a resident of another state under a DTA.

Paragraphs 9.6 to 9.8 of the DD refer to another suggestion in Chapter 13 of the Action 2 Report, namely, that a country’s domestic law include a general rule to the effect that an entity which is prima facie resident under the domestic law should be treated as non-resident for domestic law purposes if it is treated as resident of another state due to the operation of a DTA.

As acknowledged in Chapter 9 of the DD, New Zealand already has a number of domestic rules that ensure an entity which is resident of another country under a DTA cannot access certain (advantageous) features of New Zealand’s tax system. There is no discussion in the DD, however, of other domestic implications which should also, presumably, follow from applying such a rule. For instance, we assume all non-New Zealand-sourced income derived by such an entity should cease to be taxable in New Zealand, while any dividends paid would presumably cease to have a New Zealand source.

We would also be concerned that defining dual residents in terms of a relevant DTA would lead to disputes and uncertainty.

Definitions

It is difficult to submit on key definitions in advance of seeing the scope of the proposals as included in draft legislation. However, there may be a case for excluding listed, widely held instruments from the definition of structured arrangement in order to reduce some of the transitional difficulties explained in Appendix A.

Appendix C - Design Principles

Interaction with withholding taxes

We submit that NRWT should not be charged on an interest payment for which deduction has been denied.

Paragraph 11.4 proposes that denial of a deduction for payment under any of the Hybrid Rules will not affect withholding tax due. This appears contrary to a coherent, fair tax system, worsened in situations where no DTA is in place to reduce the level of withholding tax payable to an associated person.

We suggest such an approach illustrates a conceptual difficulty with the Hybrid Rule proposals. The basis, in principle, for denying deductions under a Hybrid Rule is that the item is not taxed to the recipient. While the focus of the Action 2 Report approach may be the tax treatment in the recipient's country, we see no reason why taxation by the source country by means of withholding taxes or equivalent levies should be ignored. If recipients are not taxable in their own countries, they will presumably have to bear any such source country tax as a cost. As noted earlier, the Hybrid Rules are not intended to adjust for differentials in tax rates between countries and any limitations or zero-rates applying under a DTA presumably reflect the continuing conscious and deliberate choices made by contracting governments.

Hybrid rules and anti-avoidance

We submit that the proposals should not be subject to the general anti-avoidance rule ("GAAR") due to the level of uncertainty this will cause.

Paragraphs 11.15 and 11.16 of the DD propose that the rules would apply before, and be subject to, New Zealand's GAAR and that there should also be a specific anti-avoidance rule.

We submit such an approach will create excessive uncertainty for taxpayers and seems unnecessarily punitive. Recent cases have shown that the New Zealand Courts have been willing to apply the GAAR in relation to intra-group arrangements where the New Zealand tax base may not be being eroded by comparison with alternative funding arrangements which could have been used.

In the context of the two-tier approach of the Hybrid Rule proposals and their inherent contingency of application, the perpetual risk of the GAAR being applied to supersede the outcome of applying any domestic rules, including any domestic Hybrid Rules, in New Zealand must make it difficult, if not impossible, for the cross-border parties to be able to determine whether or how their own Hybrid Rules should apply in their own jurisdiction.

Given the Commissioner's recent approach to debt capitalisations in *QB 15/01: Income tax - tax avoidance and debt capitalisation*, we are also concerned that the Commissioner's default approach to any taxpayers moving to replace any current arrangements that would or may fall subject to any Hybrid Rule adjustments would be likely simply to invoke the GAAR.

We submit that is not appropriate from an overall perspective. If an aim of Hybrid Rules is to stop taxpayers using certain types of current arrangements or transacting in certain ways, then they should not be penalised in any event because they seek to change their current arrangements to those seen as acceptable in a cross-border context.

Legislative design proposals

We submit that the Hybrid Rule proposals should be contained in primary legislation rather than subsidiary regulation.

Paragraphs 11.17 to 11.19 of the DD suggest officials may be proposing to introduce only very general Hybrid Rules in terms of the primary legislation while allowing considerable detail and future changes to be dealt with by subsidiary regulation and giving powers to the Commissioner to override the rules in some circumstances.

We submit that approach is not appropriate and would be a fundamental change to the traditional approach to tax legislation in New Zealand. It seems likely to mask insufficient initial thought and articulation of what New Zealand is seeking to achieve in principle and in detail. Constitutionally there is no place for taxing rules if they cannot be expressed fully and properly for the legislature to consider. Unlike other countries (notably the United States and Australia), New Zealand has no history of delegated tax legislation by way of Inland Revenue regulations. With few exceptions (such as items that can be changed by Order in Council) New Zealand tax is imposed by statute only.

We also draw your attention to the criticism on similar grounds recently levied at the broad scope of an amendment to the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill¹⁸ which proposes to allow transitional regulations and administrative exemptions to be made during Inland Revenue's business transformation process.

Information sharing and taxpayer secrecy

We submit that an amendment to the taxpayer secrecy provisions in s 81 of the Tax Administration Act 1994 will be required to enable Inland Revenue to release necessary information to counterparties.

The rules envisage much greater transparency of tax treatment, by both the taxpayer/s across jurisdictions and also by revenue authorities.¹⁹ Unless a specific exception to the taxpayer secrecy provisions is included, we fail to see how Inland Revenue will be able to communicate with counterparties. The exception to secrecy would need to cover information regarding matters relevant to determining the tax position taken by one party to a hybrid instrument or a hybrid payment, and how a hybrid entity treated a payment for tax purposes in New Zealand. We anticipate that equivalent rules would also be required in overseas jurisdictions.

Application of time bar

We submit that Inland Revenue needs to examine the interaction of the time bar provisions within s 108 of the Tax Administration Act 1994 with the proposals.

The DD does not mention how the time bar in s 108 of the Tax Administration Act 1994 might apply to payments that are subject to the Hybrid Rules. The time bar is to be extended to ancillary taxes including NRWT under the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill. But how will the time bar apply to deductions disallowed (under the primary rule) or payments received (under the defensive rule)?

With respect to the primary rule, the Commissioner will only be able to assess outside the usual time bar if returns containing deductions in respect of hybrid mismatches are, in the opinion of the Commissioner, "fraudulent or wilfully misleading", as there will be no "failure to mention income".²⁰ Accordingly, it is presumed the time bar will apply after four years to hybrid payments (wrongly) deducted.

With respect to the defensive rule, we anticipate the Commissioner may look to apply the time bar to unreturned hybrid payments strictly. Failures to expressly mention receipts of such payments in returns or in any related financial statements or schedules may amount to failures to mention income of a particular type or from a particular source, in which case the time bar will provide no protection. We envisage increased dispute risk on time bar issues, particularly as to whether or not receipts which may be subject to the Hybrid Rules have been sufficiently "mentioned" in a return (or in related financial statements or schedules) for the time bar to apply.

¹⁸ Supplementary Order Paper 190, introduced on 16 August 2016.

¹⁹ For example, with respect to hybrid payments at paragraph 6.27, "Unlike the reversal approach, this option would require the payee country tax authority and payee jurisdiction taxpayers to be aware of the level of non-dual inclusion income being earned in the payer country." Again, for reverse hybrids at paragraph 7.32.

²⁰ Recommendation 5.3 is that countries should have appropriate reporting and filing requirements for tax transparent entities established in their country. This involves the maintenance by such entities of accurate records of:

- the identity of the investors (including trust beneficiaries);
- how much of an investment each investor holds; and
- how much income and expenditure is allocated to each investor."

Paragraph 7.33 also states: "Recommendation 5.3 states that this information should be made available on request to both investors and the tax administration."

²⁰ See s 108(2) Tax Administration Act 1994.

15 November 2016

C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

By email policy.webmaster@ird.govt.nz

Addressing Hybrid Mismatch Arrangements – a Government Discussion Document

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Government discussion document *Addressing hybrid mismatch arrangements* (Discussion Document).
2. This submission is divided into two sections:
 - a) Section A comments on a limited number of more general issues raised in Part I of the Discussion Document; and
 - b) Section B comments on various submission points referred to in Part II of the Discussion Document.
3. All statutory references in this submission are to the Income Tax Act 2007 (the Act).

Section A: General issues raised in Part I of the Discussion Document

4. The Law Society accepts many of the proposals described in both the OECD's Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (Final Report) and the Discussion Document.
5. However, as indicated below, the Law Society is concerned that a number of the proposals contained in the Discussion Document risk placing undue burden on New Zealand taxpayers in furtherance of the global benefit sought to be achieved by them. The Law Society considers that while the adoption of the recommendations in the Final Report is in many cases appropriate (and possibly inevitable), care should be taken to ensure that New Zealand taxpayers are not unduly or unfairly impacted by the proposals.

Quantification of cost to New Zealand tax base

6. While the Law Society appreciates the notion that the Base Erosion and Profit Shifting (BEPS) initiatives are primarily designed from a global tax collection perspective, rather than with the implications for individual countries in mind, the Law Society nevertheless questions whether appropriate consideration has been given to the potential cost implications to New Zealand resulting from the proposed measures.

7. The Law Society would be interested to understand whether any analysis has been undertaken to project, for example:
 - a) the anticipated increase in the collection of New Zealand tax as a result of the implementation of the proposals;
 - b) the increased cost to New Zealand businesses in complying with the proposed measures; and
 - c) the cost to New Zealand from the potential reduction in inbound investment resulting from the proposed measures.
8. While the result of any such analysis would be only one factor in the decision to implement the hybrid proposals and would need to be balanced against the competing policy considerations detailed in Chapter 3 of the Discussion Document, there would be real benefit in attempting to understand and quantify the potential implications for New Zealand businesses. Without such analysis it is difficult to appropriately weigh the competing costs and benefits of implementation.

New Zealand tax revenue loss caused by the use of hybrids

9. The Law Society notes the comments made at paragraph 3.17 of the Discussion Document regarding the quantification of the New Zealand tax revenue loss caused by the use of hybrids:

“The New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown. However, the tax revenue at stake is significant in the cases that the Government is aware of, which shows a clear advantage to counteracting hybrid mismatch arrangements. For example, the amount at issue under all funding arrangements comparable to the Alesco arrangement referred to in Chapter 2 was approximately \$300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to some prominent hybrid entity structures result in approximately \$80 million less tax revenue for New Zealand per year.” [emphasis added]

10. The Law Society considers that this statement significantly overstates the potential cost to the New Zealand tax base from the use of hybrids.
11. Taking the *Alesco*-style optional convertible note arrangement referred to in the paragraph – the Discussion Document suggests that the cost to the New Zealand tax base of the deductions claimed by the various taxpayers under those optional convertible note instruments was (leaving to one side the successful application of the general anti-avoidance rules) the entire \$300 million of deductions collectively claimed by those taxpayers. That significantly overstates the cost. Absent the convertible note arrangements, many of the relevant taxpayers are likely to have been funded into their New Zealand activities with interest bearing debt. It is also likely, given the nature of the “holder election” instruments entered into in those cases, that the interest on that debt funding would have been paid at a higher rate than that treated as having been incurred under the convertible notes. The

elimination of a deduction no inclusion (D/NI) outcome in these cases would, in all likelihood, have resulted in a cost to New Zealand.

New Zealand's tax sovereignty

12. The Law Society notes that in many respects the proposals contained in the Discussion Document compromise the implementation of rules and policies that New Zealand has previously determined to be the appropriate basis of taxation from a country standpoint, best serving its interests domestically and internationally.
13. This point can be demonstrated through the example contained at paragraphs 5.29 to 5.30 of the Discussion Document. Under that example, a New Zealand purchaser of assets pays a deferred purchase price giving rise to deductions for the purchaser under the financial arrangements rules. If no income is recognised in the vendor's home jurisdiction, the sale and purchase arrangement would give rise to a D/NI outcome, which in certain circumstances would result in the deduction being denied under the proposed linking rule.
14. New Zealand has determined that taxation on an accruals basis under the financial arrangements rules represents the most appropriate manner of taxing financial arrangements. That regime risks being seriously eroded through the application of the linking rule in the example given above.
15. The recommendations in relation to the deactivation of domestic transparency in Recommendation 5.2 of the Final Report provide a further and important example. The recommendation, if implemented, has the potential to upset basic principles of New Zealand taxation – in particular, the non-taxation of foreign-sourced income derived by non-residents. This could have a significant impact on New Zealand's desirability as a destination for investment and its financial and professional services industry. These basic principles should not be eroded without careful consideration of the potential cost to New Zealand.
16. The question is whether it is appropriate for New Zealand to compromise the operation of its rules and policies to effectively compensate for shortcomings in the global tax net, arising from the less comprehensive or poorly designed methods of taxation implemented in other tax jurisdictions.
17. That compromise may be difficult to avoid as a result of combating some hybrid mismatches, but care should be taken to limit the impact of the proposed rules on New Zealand's existing tax policy to the greatest extent possible.

Section B: Responses to submission points identified in Part II of the Discussion Document

Submission point 5A

Outline of proposal

18. As part of Recommendation 2 in the Final Report, the OECD recommends that countries amend their domestic tax rules to ensure that a dividend exemption is denied in respect of

deductible payments made under financial instruments. This recommendation has no limitation on its scope.

19. New Zealand already denies the foreign dividend exemption in respect of rights to a foreign equity distribution under section CW 9(2)(c). This section is proposed to be expanded to also deny the foreign dividend exemption in circumstances where a dividend is paid, and the payment of the dividend gives rise to a tax credit in the payer jurisdiction.

Comment and recommendation

20. The Law Society anticipates that this proposal will be difficult for many taxpayers to comply with. Because the proposed amendment to section CW 9(2)(c) would be of general application, it is likely that in many circumstances the recipient of the dividend will be unable to determine whether the company paying the dividend is entitled to a tax credit in its home jurisdiction.
21. The Law Society recommends that the proposed amendment to section CW 9(2)(c) be limited to apply only in circumstances where the recipient of the dividend has reason to believe that the company paying the dividend is entitled to a tax credit in its home jurisdiction in respect of that dividend payment. This (or similar) test could be supported by guidance from the IRD in relation to the circumstances in various jurisdictions which would be likely to result in the application of the proposed amendment to section CW 9(2)(c). There is no reason that the “reason to believe” (or similar) test could not also be applied to the current deductible dividend limitation of the foreign dividend exemption, in respect of which there must also be difficulties with compliance.

Submission point 5C

Outline of proposal

22. The Final Report confirms that the hybrid financial instrument rule should not generally apply to differences in timing between the recognition of payments under a financial instrument.
23. Accordingly, it is recommended that no D/NI outcome should arise if the tax administration can be satisfied that the payment under the instrument is expected to be included in income within a reasonable period following the deduction.
24. The Final Report states in paragraphs 55 - 60 that this concept should be triggered if:
 - a) the payment will be included by the payee in ordinary income in an accounting period that commences within 12 months of the end of the payer’s accounting period; or
 - b) the tax administration is otherwise satisfied that the payee can be expected to include the payment in ordinary income “within a reasonable period of time”.
25. The Discussion Document notes that an alternative approach has been advocated in the Australian Board of Taxation Report, under which an income recognition deferral of up to

three years would not attract operation of the hybrid rules.¹ Further, where a deduction is denied because of a deferral of more than three years before recognition, that deduction denial would be reversed upon the subsequent inclusion of the relevant income.

26. The Discussion Document seeks submissions on whether the Australian Board of Taxation approach in respect of timing mismatches under a hybrid financial instrument would be acceptable in New Zealand, or whether an alternative option (such as that proposed in the OECD's Final Report and implemented in the United Kingdom) would be preferable.

Comment and recommendation

27. The Law Society agrees with the comments made at paragraph 5.45 of the Discussion Document that an approach similar to that advocated by the Australian Board of Taxation, which operates based on the application of objective timeframes rather than a subjective "reasonableness" test, would be appropriate in respect of the New Zealand's self-assessment tax system.
28. The Law Society further considers a timing gap of three years to be reasonable in determining whether a timing mismatch has arisen which should be subject to the hybrid mismatch rules (before reversal on any subsequent inclusion).
29. The Law Society also submits that it would be appropriate to incorporate a de minimis threshold in respect of the quantum of the deduction before the rules could apply. For example, if after a three year period the deduction(s) claimed exceeds the recognition of income by more than, say, \$50,000, the rules would apply. The introduction of such a de minimis threshold would ease taxpayer compliance costs for what is ultimately only a timing advantage.
30. The Law Society also supports the proposal to allow for a carry-forward of any deductions temporarily denied under this proposed rule. Because the only advantage obtained by a taxpayer under an arrangement subject to this rule is a timing advantage, it is appropriate to only counteract that timing advantage and not the deduction in its entirety.

Submission points 5D and 6D

Outline of proposal

31. The Discussion Document proposes to disregard controlled foreign company (CFC) taxation in respect of considering both:
 - a) whether there is inclusion for the payee for the purposes of assessing whether a D/NI outcome arises in respect of Recommendation 1 (submission point 5D); and
 - b) whether dual inclusion income arises for the purposes of preventing the application of the disregarded hybrid payments rule in Recommendation 3 (submission point 6D).

¹ <http://taxboard.gov.au/files/2016/05/Implementation-of-the-OECD-hybrid-mismatch-rules.pdf>

32. The reasons given at paragraph 5.47 of the Discussion Document for the proposal to disregard CFC taxation for the purposes of Recommendation 1 are that:
- (i) it will sometimes be complex to establish the extent of CFC taxation;
 - (ii) there is no need to do so when applying the secondary response; and
 - (iii) taxpayers can use alternatives to hybrid instruments.
33. The reason given at paragraph 6.28 in relation to Recommendation 3 is that it will avoid drafting a large amount of very detailed and targeted legislation which is aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise.

Comment and recommendation

34. The Law Society opposes the proposal to disregard CFC taxation in the above circumstances.
35. The hybrid proposals should consist of a set of fair and principled rules to limit instances of non-taxation, rather than to impose penal double taxation. This point is commented on at paragraph 36 of the Final Report, where the OECD states that in respect of inclusion under a CFC regime:
- “The hybrid financial instrument rule is only intended to operate where the payment gives rise to a mismatch in tax outcomes and is not intended to give rise to economic double taxation.” [emphasis added]*
36. This point is again reiterated at paragraph 49 of the Final Report, which considers the nature and extent of the adjustment required under the hybrid financial instrument rule:
- “The adjustment should be no more than is necessary to neutralise the instrument’s hybrid effect and should result in an outcome that is proportionate and that does not lead to double taxation.” [emphasis added]*
37. The Law Society does not find the reasons given at paragraphs 5.47 and 6.28 of the Discussion Document convincing. Ignoring CFC inclusion does not lead to a proportionate outcome. Each of the hybrid proposals will involve a complex set of rules which will be difficult to apply for taxpayers and the IRD alike. The complexity rationale would work against the implementation of any of the proposals. Similarly, the ability in many circumstances for a taxpayer to use alternative non-hybrid financing instruments does not justify the imposition of economic double taxation. If encouraging taxpayers to use alternative instruments is a key element of the non-inclusion, then a more appropriate and far less complex approach would be simply to prohibit the use of hybrids. As it stands, the proposals seek to counteract hybrid tax mismatches. It should be designed to do that successfully and not more.
38. If there are potential difficulties in establishing the extent of CFC taxation under some CFC regimes, the appropriate response would be for the relevant taxpayer to be subject to the burden of establishing that CFC taxation to the IRD. This is the approach adopted in the

OECD's Final Report, as summarised at paragraph 5.27 of the Discussion Document, and is the one that the Law Society considers should be adopted in New Zealand.

Submission point 5E

Outline of proposal

39. The Discussion Document outlines at paragraph 5.50 three possible approaches to address situations where a New Zealand resident holds an attributing interest in a foreign investment fund (FIF) which is subject to New Zealand tax under one of the fair dividend rate (FDR), cost, or deemed rate of return (DRR) methods.
40. Under current law a taxpayer applying one of these methods would be exempt from tax on any distributions received from the FIF. That would as a technical matter give rise to a D/NI outcome so as to potentially necessitate (if deductible in the payer jurisdiction) the denial of the deduction in the FIF country, or the inclusion of income in New Zealand.
41. In general terms, the three proposals outlined in the Discussion Document are to:
 - a) deny the FDR, cost and DRR methods to FIF interests on which deductible distributions would be made (Option A);
 - b) treat a deductible distribution as income of the New Zealand taxpayer in addition to any income recognised under the FDR, cost or DRR methods (Option B); or
 - c) treat a deductible distribution as income of the New Zealand taxpayer, to the extent that income has not already been recognised under the FDR, cost or DRR methods (Option C).

Comment and recommendation

42. In the Law Society's view, the order of preference of the above options is as follows (with the most preferable first): Option C, Option A, Option B.
43. Option C is the only option that would:
 - (i) prevent a D/NI outcome from arising so as to satisfy the hybrid mismatch objectives;
 - (ii) ensure that taxpayers are not subject to double taxation; and
 - (iii) allow impacted taxpayers the flexibility to continue to use the FDR, cost and DRR methods in respect of such investments.
44. Option B is the least preferable solution because it could result in economic double taxation for impacted taxpayers. As described above, the Law Society considers that the hybrid proposals should consist of a set of fair and principled rules which seek to limit instances of non-taxation and result in a proportionate outcome, rather than to impose penal double taxation on a taxpayer.

Submission point 7A

Outline of proposal

45. The reverse hybrid rule contained in Recommendation 4 of the Final Report seeks to neutralise D/NI outcomes arising from a payment made to a reverse hybrid. The proposal consists solely of a primary rule under which the payer jurisdiction will deny the deduction to the extent of the mismatch. The application of this rule is limited in scope to situations where the investor, reverse hybrid and payer are all members of the same control group, or there is a structured arrangement.
46. The Discussion Document seeks submission on whether there are any issues relating to implementing Recommendation 4 in New Zealand.

Comment and recommendation

47. The Discussion Document does not directly comment on whether inclusion as CFC income would be sufficient to prevent the application of a D/NI outcome from arising. However, given the comments detailed above in relation to the Discussion Document's treatment of CFC income in respect of Recommendations 1 and 3, it would appear likely that such income would be disregarded.
48. This outcome would be contrary to the statements made at paragraph 150 of the Final Report, which recommends that provided the taxpayer can establish such inclusion to the satisfaction of the tax authority:

"A payment that has been fully attributed to the ultimate parent of the group under a CFC regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the reverse hybrid rule."
49. Consistent with the recommendation of the Final Report, and with the comments made above in respect of Recommendations 1 and 3, the Law Society submits that CFC inclusion should be treated as relevant for the purposes of implementing Recommendation 4 in New Zealand.

Submission point 7B

Outline of proposal

50. Recommendation 5.1 involves amendments to New Zealand's offshore investment regimes (the CFC and FIF regimes) to ensure that payments made to "reverse hybrids" which are fiscally transparent in the establishment country are subject to owner-level taxation in New Zealand.
51. By way of example, the Discussion Document anticipates that one method for counteracting such arrangements would involve an amendment to the CFC rules to provide that the owners of a CFC would be attributed with any income of the CFC to the extent that the establishment jurisdiction allocates that income to the owner for income tax purposes, and

that income is not subject to tax in that establishment jurisdiction as a result of that allocation (Option A).

52. The Discussion Document suggests two other solutions which have been adopted elsewhere:
- a) the United Kingdom has adopted a narrower rule which would only include an amount as income of a United Kingdom investor to the extent to which a D/NI outcome arises having regard to the application of the hybrid rules in other jurisdictions (Option B); and
 - b) Australia already contains rules which seek to counteract mismatches arising from the use of reverse hybrids established in other countries, whereby a list of foreign entities is maintained that are treated as partnerships under Australian law to the extent to which they are fiscally transparent in their establishment jurisdiction (Option C).

Comment and recommendation

53. The Law Society considers that Options B or C would be more appropriate for adoption in New Zealand.
54. Option A has the potential for overreach, in that it might act to attribute CFC income to New Zealand investors in circumstances where the hybrid rules have already operated in another jurisdiction to prevent a D/NI outcome. That would contribute to a no deduction / income outcome. That outcome should not be risked if there are feasible alternative options (such as Options B and C).

Submission point 7D

Outline of proposal

55. Recommendation 5.2 in the Final Report encourages countries to implement domestic rules to deactivate tax transparency rules that achieve hybrid mismatches. The recommendation targets a situation where:
- a) an entity is tax transparent under the laws of the establishment jurisdiction;
 - b) the person derives foreign source income or income that is not otherwise subject to taxation in the establishment jurisdiction; and
 - c) all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.
56. The Discussion Document confirms that in a New Zealand context, this could involve the taxation of the foreign-sourced income of partnerships and foreign trusts established in New Zealand where the income is allocated to an offshore investor within the same control group as the reverse hybrid, and the offshore investor treats the reverse hybrid as fiscally opaque.
57. In the case of foreign trusts, this rule would also potentially apply to require taxation in New Zealand where the income is treated as trustee income in New Zealand and is not taxed in any other jurisdiction.

Comment and recommendation

58. These proposals would involve New Zealand taxation of non-residents' foreign-sourced income. This is a fundamental change to long-standing tax policy.
59. Subsection BD 1(5) currently provides for the exclusion of non-residents' foreign-sourced income from the calculation of a person's assessable income. This is an outcome of New Zealand's right to tax being limited by the core principles of residence and source. In a trust context, section HC 26 operates to exempt foreign sourced income derived by a resident trustee where no settlor of the trust is resident in New Zealand (other than a transitional resident).
60. The June 2016 *Government Inquiry into Foreign Trust Disclosure Rules* (the Shewan Report) recently confirmed that the foreign settlor/resident trustee exemption represented sound tax policy. Paragraph 4.18 of the Shewan Report comments:

"The Inquiry considers that the current tax treatment of foreign trusts is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy."

61. The Law Society considers that New Zealand should only adopt rules that abandon traditional limitations to taxation on the basis of residence and source as a last resort, and then in the most limited manner possible.
62. At least in relation to the use of New Zealand foreign trusts, the Shewan Report was satisfied that the introduction/enhancement of the various information reporting requirements for foreign trusts was sufficient to maintain New Zealand's international reputation without abandoning core principles of taxation. Perhaps similar disclosure rules in relation to New Zealand partnerships and other transparent entities would be sufficient to do the same without New Zealand taxing non-residents' foreign sourced income.

Submission point 9A

Outline of proposal

63. Recommendation 7 deals with situations where one entity is resident in two different countries, and is entitled to a deduction in each of those countries for a single payment.
64. The proposal is for both countries to deny the deduction to the extent that it is offset against non-dual inclusion income.

Comment and recommendation

65. Paragraph 9.3 of the Discussion Document acknowledges that where both residence countries have hybrid rules, it is possible for the disallowance of deductions under this recommendation to give rise to a double taxation outcome. However, the Discussion Document suggests that because in most cases dual residence status is deliberate rather than accidental, this outcome should be able to be avoided by taxpayers.

66. The Law Society makes two comments in relation to this approach.
67. First, it is incorrect to assume that, in most cases, dual residence status can easily be avoided or might be deliberately pursued by taxpayers. In many practitioners' experience, it is perceived by taxpayers as a risk to be managed because of the potential to create unwanted tax outcomes ranging from taxation in non-treaty jurisdictions to the denial of benefits similar to New Zealand's imputation regime (denied to dual resident entities).
68. A business operated cross-border can easily necessitate commercial units being established offshore. The autonomy of those units may range in practice depending on a number of factors: consumer preference; market size; local laws and customs; etc. In most cases, commercial (non-tax considerations) will dictate the level of presence and organisational control exercised in another jurisdiction.
69. The interaction of domestic tax residency rules that contain alternative tests for residency is not always clear and the risk of unintended dual residence is very real. This risk is heightened the more factually dependent the various tests are. The head office, centre of management and director control tests in section YD 2 are not straight-forward to apply in many cases and involve a factual inquiry with overlapping considerations. Each can involve a balancing of positive and contrary considerations in arriving at a view on application. The Law Society has not performed a review of the corporate tax residency rules in other jurisdictions. However, it is not difficult to imagine a range of different tests being applied to determine corporate residence status. The boundaries of the various tests in different jurisdictions based on anything but incorporation (or equivalent) can be expected to involve many of the same difficulties encountered in the application of our own tests for corporate tax residency. This all heightens the risk of unintended dual residence.
70. It is also possible that taxing authorities could reach inconsistent views on the application of similar tests following their own factual review and balancing other considerations.
71. Secondly, the Law Society submits that, regardless of whether dual residence status may be able to be avoided by taxpayers, the potential double taxation outcome envisaged by this proposal should not be pursued.
72. This proposal is another example of the rules deliberately imposing a double income penalty rather than simply addressing the tax result of hybridity. That approach risks overreach in a regime that addresses the outcome of hybrids as opposed to directly controlling their use.
73. The Law Society considers that the introduction of primary and defensive rules to ensure that the deduction is disallowed in only one of the countries in which the taxpayer is resident to be preferable to rules that risk double taxation.

Submission point 9B

Outline of proposal

74. At paragraphs 9.6 to 9.8 of the Discussion Document it is stated that the OECD Final Report encourages the adoption of a domestic law rule which deems an entity to not be resident for tax purposes if they are resident in another country through the operation of a double taxation agreement (DTA).

Comment and recommendation

75. The Law Society queries how in practice this proposal would interact with the proposed amendments to Article 4(3) of the OECD Model Tax Convention (discussed at paragraph 4.33 of the Discussion Document) which would provide that the tiebreaker mechanism for residence in a DTA will be resolved by the competent authorities of each DTA partner rather than through an interpretive rule as to the place of effective management.
76. The Law Society recommends that consideration be given to either (or both):
- a) publishing guidelines to ensure that taxpayers will be aware of the types of circumstances which would be likely to result in them being deemed to be resident in New Zealand for DTA purposes through this competent authority mechanism;
 - b) a streamlined competent authority process so that taxpayers can obtain clarity upfront and in a timely way as to their residence status for tax purposes.
77. If taxpayers would lose their New Zealand tax residence status as a result of a decision of the competent authorities, taxpayers should be informed of the circumstances which would lead to such a decision, and should not be left in doubt for any significant period awaiting such a decision.

Submission point 10

Outline of proposal

78. Recommendation 8 deals with imported mismatches which arise when:
- a) a payment is made to a recipient in a country that does not have hybrid mismatch rules;
 - b) that particular payment does not give rise to a hybrid mismatch; but
 - c) the recipient of that payment enters into a hybrid mismatch arrangement with a third party in another jurisdiction.
79. The proposal is that where the imported mismatch rule applies (i.e. within a control group or as part of a structured arrangement) a deduction for the original payment would be denied even though it does not give rise to a hybrid mismatch itself.

Comment and recommendation

80. The Law Society submits that the imported mismatch rule is likely to give rise to significant compliance costs concerns for New Zealand taxpayers in circumstances where the mischief arises entirely outside New Zealand, and the likely revenue collection will be minimal.
81. Requiring New Zealand taxpayers to consider the tax treatment in two other jurisdictions before claiming a deduction is unduly onerous.
82. If the imported mismatch rule is to be introduced in New Zealand, the Law Society submits that as indicated at paragraph 10.11 of the Discussion Document, adequate de minimis and safe harbour thresholds be introduced. It would make sense for New Zealand to set these de minimis and safe harbour thresholds at the same or similar levels to those decided upon in Australia, to ensure consistency across the two jurisdictions for subsidiaries in multinational groups which operate in both New Zealand and Australia.

Submission point 11A

Outline of proposal

83. At paragraph 5.10 of the Discussion Document it is suggested that the imposition of withholding tax on a payment is not full taxation as ordinary income (with the resulting implication that a deductible payment which is subject to withholding tax in the payer jurisdiction will be treated as a D/NI outcome, with that payment being deemed to be non-deductible).
84. At paragraph 11.4 of the Discussion Document it is then suggested that where a deduction is denied under the hybrid rules, this would not affect the underlying withholding tax treatment on that payment.

Comment and recommendation

85. The combined effect of these two statements will result in an overreach of the hybrid proposals. If the deduction on the payment which produces the D/NI outcome is denied in its entirety, but is still subject to withholding tax under the NRWT rules, the operation of the hybrid rules will result in an asymmetrical partial inclusion/no deduction outcome.
86. This is entirely inconsistent with the tenor of the NRWT proposals contained in the recent *May 2016 Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill*. One of those proposals was to broaden the NRWT rules to apply in circumstances where a borrower that is an associated person of the lender incurs deductible financial arrangement expenditure.
87. As described at paragraph 2.21 of the *May 2015 NRWT: related party and branch lending* issues paper, that proposal was one of a number of changes intended to ensure symmetry between the tax treatment under the financial arrangements rules (under which a deduction

to the payer was allowed) and the NRWT rules (which previously did not impose a withholding obligation on financial arrangements rules expenditure):

“The suggested changes in this issues paper are aimed at helping ensure a more appropriate amount of tax is paid by non-residents on their New Zealand sourced income, thus better aligning taxation with real economic activity and reducing current asymmetries.”

88. It appears inconsistent to advocate for the need for alignment between deductibility and the imposition of NRWT in support of the proposal to broaden the scope of the NRWT rules on one hand, but on the other to suggest that alignment is unnecessary where a deduction is denied to the payer under the hybrid proposals.
89. The Law Society submits that the principle of alignment between the NRWT rules and the financial arrangements rules should be respected under the hybrid proposals as well as the proposal to increase the scope of the NRWT rules. This could be achieved by either:
- a) only partially denying a deduction under the hybrid rules in respect of a deductible payment that is subject to NRWT, but does not produce income in the country of the recipient, reflecting that there is not a full D/NI outcome; or
 - b) (more simply) relieving a payment from the imposition of NRWT where a deduction on that payment has been denied under the hybrid proposals.

Submission point 11D

Outline of proposal

90. At paragraphs 11.17 to 11.19 the Discussion Document considers the merit of legislating in broad principles which could be “fleshed out” by regulations of some kind.

Comment and recommendation

91. The Law Society submits that, to the greatest extent possible, the detail of the hybrid mismatch rules should be expressed in the Act rather than in regulations.
92. While regulations may provide a more flexible option which would allow for the rules to be more easily amended over time, there is a risk that:
- a) flexibility in amendment may compromise taxpayer certainty; and
 - b) amendments would be made without full consultation.

Submission point 11E

Outline of proposal

93. The Discussion Document puts forward the view that because the impact of the hybrid mismatch proposals will in most cases be able to be established now by reference to the OECD’s Final Report, there is no need to introduce any grandfathering provisions.

94. Instead, the new hybrid mismatch rules would apply to payments made after a taxpayer's first balance date following enactment. Taxpayers are considered to have enough time between the introduction of the relevant legislation and its enactment to restructure any arrangements which might be impacted by the proposal.

Comment and recommendation

95. The Law Society submits that taxpayers should be afforded a reasonable period of time to consider any hybrid mismatch legislation in its final form, and to implement any restructuring arrangements prior to the effective date.
96. Whether the proposed timeframe set out in the Discussion Document would in practice afford taxpayers such time will be likely to be determined by the period of time it takes from introduction to enactment, and the significance of any changes to the draft legislation produced at introduction.

Conclusion

97. This submission has been prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

A handwritten signature in black ink, appearing to be 'Kathryn Beck', written in a cursive style.

Kathryn Beck
President

11th November 2016

#019

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir or Madam,

Submission on Addressing hybrid mismatch arrangements

We thank you for the additional time granted to submit on this topic.

The focus of our submission is Submission point 7D relating to the OECD's Recommendation 5.2.

We disagree with the suggestion made in paragraphs 7.28 and 7.29 of the discussion document that trust classifieds as foreign trusts under part HC of the Income Tax Act 2007 represent "reverse hybrids". Accordingly, applying the OECD's Recommendation 5.2 the discussion document suggests foreign trusts should become taxable on their non-New Zealand sourced income "*to the extent that that income is not taxed in any other country*" (Paragraph 7.29).

We consider this proposal is based on an incorrect assumption that the Income Tax Act 2007 ("the Act") attributes trust income to the settlor (so therefore a trust has look through tax treatment and is fiscally transparent).

The Act treats a trust as a separate person for income tax purposes, and not as a fiscally transparent entity similar to a look-through company or the United States "Grantor Trust" regime. Under sections HC 6 and HC 7 of the Act, income derived by a trustee of trust may be distributed to a beneficiary in which case it is effectively treated as a deduction for the trustees. If no allocation is made, then the income is treated as that of the trustees. This is not the characteristic of a fiscally transparent entity. The trust is not a fiscally transparent entity but fiscally opaque. On that basis a foreign trust could not be a reverse hybrid and Recommendation 5.2 should not apply.

We are also concerned that this proposal is contrary to current tax policy regarding the taxation of non-New Zealand sourced income derived by non-residents. Section BD 1(5) of the Act excludes such income from the definition of assessable income. With regard to trusts, section HC 26 treats foreign-sourced income derived by a New Zealand resident trustee as exempt income where no settlor of the trust is tax resident in New Zealand (other than a transitional resident).

Furthermore we note paragraph 4.18 of the recent *Government Inquiry into Foreign Trust Disclosure Rules* undertaken by Mr John Shewan commented:

"The Inquiry considers that the current tax treatment of foreign trusts is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy."

Mr Shewan's Inquiry had a very wide-ranging brief and given his endorsement of the current tax policy, we see no basis for what would be a dramatic change of established tax policy particularly as it appears to be based on a misunderstanding of how the Act currently regards a trust.

We would be pleased to discuss any of the issues raised in this submission with officials.

Yours faithfully,
BAUCHER CONSULTING LIMITED



Terry Baucher LLB M.ATAINZ TEP
Director

NEW ZEALAND NEEDS A TAILORED APPROACH TO THE OECD'S PROPOSALS TO NEUTRALISE SO-CALLED "HYBRID MISMATCH ARRANGEMENTS"

David Patterson / Peter North

SUMMARY

- 1 This paper advocates for New Zealand to take a "tailored" approach to the "OECD Hybrid Report"¹ proposals. Under this tailored approach:
 - NZ should reject any presumption that, without the need for further thought, the UK "General Principle Overlay Approach" should be adopted;
 - NZ should make deliberate policy decisions in NZ's interest as regards each of the OECD policy recommendations and the extent to which each is adopted by NZ. To the extent the OECD proposals are to be adopted, specific new rules should be integrated into the existing statute (not served up as a stand-alone overriding subpart of the statute);
 - some of the OECD Hybrid Report proposals should not be adopted at this time. At this stage our view is that rules that deny to foreign direct investors NZ interest deductions which would otherwise be allowed within NZ's existing framework should not be adopted. Such rules include the imported mismatch rule, the rule as regards disregarded payments by hybrid entities and the rule as regards payments made to a reverse hybrid.
- 2 The compelling reason for the suggested tailored approach is that adoption of the UK General Principle Overlay Approach, without further thought, would potentially have a significant adverse impact on the NZ Government's current policy emphasis on attracting more foreign direct investment into NZ.
- 3 There are a range of other reasons supporting the tailored approach: that hybrid mismatch issues are not a significant threat to the NZ tax base; that the full OECD Hybrid Report proposals are mind-boggling in their complexity (and NZ is not a "rhinoceros", see below); and that there are significant flaws in the foundations of the OECD Hybrid Report proposals. But in our view the Government's own policy as regards attracting FDI compels the tailored approach.

THE OECD PROPOSALS

- 4 The OECD Hybrid Report contains strong recommendations for major international tax changes requested to be delivered broadly by concerted domestic law tax changes by member countries.
- 5 The concern broadly addressed by the OECD Hybrid Report is double non-taxation, i.e. non-taxation (or low taxation) in both the source country of income and the country of residence of the investor. The report broadly targets hybrid mismatch arrangements that exploit a difference in tax treatment of an instrument or an entity

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

under the laws of two or more countries which lowers the total tax costs to the parties to the arrangement.²

6 More specifically, the OECD Hybrid Report contains 8 recommendations for changes to the domestic law of member countries and a smaller group of recommendations for changes to the tax treaties. This paper focusses on the recommended domestic law changes. The outcomes sought to be counteracted by the OECD are broadly:

- **Deduction no inclusion outcomes (“D/NI”)**: Payments giving tax deductions under the rules of the payer country and are not included in the ordinary income of the payee. The OECD proposed rules broadly target D/NI outcomes as a result of:
 - (a) “hybrid instruments”; and
 - (b) “hybrid entities”.
- **Double deduction outcomes (“DD”)**: Payments that give rise to deductions in two or more countries for the same payment resulting from hybrid entities or dual residents;
- **Indirect deduction/no inclusion (“Indirect D/NI”)**: Payments that are deductible under the rules of the payer country and are set-off by the payee against a deduction under a hybrid mismatch arrangement. This is covered in rules directed at “imported mismatch arrangements”.

Recommended rules to address D/NI outcomes

7 More specifically, but still at the helicopter level, we outline below the targets of the OECD’s recommendations as regards D/NI outcomes. Yes, unfortunately even for a reasonably high level paper addressing NZ’s policy response at a high level, we need to start by having some understanding of the detailed subject matter. Without that, no sensible conclusions can be drawn as to the best overall approach.

Hybrid Instruments

8 These are circumstances where a D/NI outcome is the result of:

- the terms of the financial instrument (broadly the payer country allows a tax deduction and the payee does not include income, for example because one country treats the payment as deductible interest and the other treats the payment as a tax-exempt dividend). See Examples 1 and 3 in the Appendix; or
- a hybrid transfer, by which is meant broadly a transfer of a financial instrument on terms where a mismatch arises because, following the transfer, one country treats the transferee as the owner of the financial instrument and another country treats the transferor as the owner of the same financial instrument. Sale and repurchase (“repo”) agreements are an example; or
- substitution payments, by which are meant broadly payments under a transfer of a financial instrument which involves the making of payments

² OECD *Neutralising the Effects of Hybrid Mismatch Arrangements*, (2014) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, at paragraph 41.

between the counterparties in substitution for the underlying return on the financial instrument. Securities lending arrangements are an example.

- 9 Hybrid instruments are covered in Recommendation 1 of the OECD Hybrids Report. The suggested primary response is for the payer country to deny the deduction for the payment to the extent that it gives rise to a D/Ni outcome. A secondary “defensive” rule is also recommended: if the payer country does not act to deny the deduction, the payee country should in its domestic law require the payment to be included in ordinary income to the extent the payment gives rise to a D/Ni outcome.
- 10 There then follow clarifications/exceptions, including that:
- the rule only applies to payments between “related persons” (generally 25% direct or indirect common ownership between the payer and payee) or pursuant to a “structured arrangement”;
 - the rule does not apply to mismatches solely attributable to the status of the taxpayer or the circumstances in which the instrument is held;
 - the rule does not apply to timing differences provided that the income arises within a “reasonable period of time”;
 - the rule does not apply to certain investment vehicles;
 - “payments” do not include “payments that are only deemed to be made for tax purposes and that do not involve the creation of rights between parties” (consequently, OECD’s recommendations do not target accounting entries such as debt forgiveness or foreign exchange fluctuations for example, as debt forgiveness is not a “payment” made and foreign exchange differences are said only to reflect the nominal values assigned by jurisdictions to a payment rather than constituting payments in and of themselves³).
- 11 This rule is reinforced by Recommendation 2 which specifically requires that a payee country should not grant a dividend exemption for dividend payments that are treated as deductible by the payer. NZ law already provides for this outcome – see sections CW 9(2)(b) and (c) of the Income Tax Act 2007. Recommendation 2 also extends to restrict dual claiming of foreign tax credits for withholding tax at source under “hybrid transfers” (see above) where two countries see different persons as the tax owner of a transferred financial instrument.

Hybrid Entities

- 12 The disregarded hybrid entities rule in Recommendation 3 will most commonly apply where the payer entity is treated as opaque (a separate entity) by the payer country and transparent by the payee country. This rule targets a D/Ni outcome that arises from a disregarded payment, which is a payment: deductible under the laws of the payer country; and that is not recognised under the laws of the payee country by reason of the tax treatment of the payer under the payee country’s laws (i.e., generally, where the payee country treats the payer as transparent).
- 13 The suggested response is for the payer country to deny the deduction for the payment to the extent that it gives rise to a D/Ni outcome. A secondary “defensive”

³ See analysis in OECD Hybrid Report at examples 1.17 and 1.20.

rule is also recommended: if the payer country does not act to deny the deduction, the payee country should in its domestic law require the payment to be included in ordinary income of the payee to the extent the payment gives rise to a D/Ni outcome.

- 14 Again and similar to Recommendation 2, there are clarifications and exceptions, including that:
- the rule does not apply to the extent the deduction to the payer in the payer country is set-off against income that is included in income under the laws of both the payee and the payer countries (i.e., "dual inclusion income"), with any deduction in excess of the dual inclusion income being quarantined and offset against dual inclusion income in a future period;
 - the rule applies only to parties in the same "control group" (generally 50% or greater direct or indirect common ownership) or for parties to a "structured arrangement";
 - the rule can apply to current expenditure such as interest, service payments, rents and royalties. But it does not apply to the cost of acquiring a capital asset or depreciation allowances.
- 15 Recommendation 4 addresses D/Ni outcomes from payments to "reverse hybrids". A "reverse hybrid" is any person that is treated as a separate entity by an 'investor country' (i.e., the country of residence of investor) and transparent in the 'establishment country' (i.e., where the entity is established). Reverse hybrids will most commonly involve payments from a 'third country' (i.e., where the payer is located) to the payee (the reverse hybrid and in which the investor invests) that is transparent in the payee country, but treated as a separate entity by the investor under the investor country's tax law. See Example 2 in the Appendix.
- 16 The suggested response in Recommendation 4 is for the payer country (i.e., the country from which the payer makes the payment to the reverse hybrid) to deny the deduction to the extent the payment gives rise to a D/Ni outcome.
- 17 The clarifications/exceptions to the Recommendation 4 rule are that:
- the rule only applies where the investor/the reverse hybrid and the payer are members of the same control group (generally 50% or more common control) or if the payment is under a "structured arrangement" to which the payer is a party; and
 - the rule only applies if the D/Ni outcome would not have arisen if the payment was made direct by the payer to the investor.
- 18 Recommendation 5 recommends further countering reverse hybrids by: investor countries tightening their CFC rules to prevent D/Ni outcomes for payments of reverse hybrids; and if the investor country does not act, the establishment country of the reverse hybrid bringing the reverse hybrid income into its tax net.
- 19 Recommendation 8 introduces the 'imported mismatch rule' to address D/Ni outcomes which occur in multiple jurisdictions other than the payer country, but due to a lack of anti-hybrid rules are not addressed by those countries, and accordingly, are effectively 'imported' into the payer country. The suggested response in

Recommendation 8 is for the payer country to deny a deduction to the extent the payment from the payer country produces an indirect D/NI outcome under the rules of the payee country and another country. See Example 4 in the Appendix.

- 20 The clarifications/exceptions to this rule are that the payer, the payee and the other party must be within the same control group or the payment by the payee is under a "structured arrangement" to which the payer is a party.
- 21 This rule is hideously complex/ highly controversial and is addressed further below in the context of its potential negative impact on NZ's attraction of FDI. As noted in the OECD Hybrid Report, the imported mismatch rule would not be necessary with universal adoption of the other anti-hybrid recommendations, as the mismatch occurring between a payee country and another country would already be counteracted. See example 4 in the Appendix.

Recommended rules to address DD outcomes

- 22 Recommendation 6 addresses DD outcomes (deductions in two or more countries for the same payment) that are the result of an entity being a "hybrid payer". A hybrid payer broadly arises when:

- a company has a branch and a deduction is allowed for a payment both in the country where the branch is established and in the country where the company is formed; and
- an entity resident in a payer country is allowed a deduction for a payment in the payer country but a deduction is also allowed to the investor (or a related person) in the entity because the entity is treated as transparent under the law of the investor country.

(The rule is stated more broadly, but these are the two primary examples.)

- 23 The suggested response is that the establishment country of the company with the branch/the investor country should deny the duplicate deduction to the extent it gives rise to a DD outcome. If that country does not act, a defensive rule is suggested under which the branch country/payer country should deny the deductions.
- 24 Clarifications/exceptions include that: the defensive rule only applies if the parties are in the same control group or the DD outcome arises under a "structured arrangement" and the branch/the payer are parties; the rule does not apply to the extent the deduction is set-off against dual inclusion income (to the extent exceeding current dual inclusion income, the deduction may be quarantined and offset against future dual inclusion income); the rule can apply to current expenditure, but does not apply to the cost of acquiring a capital asset or depreciation allowances.
- 25 Recommendation 7 counters DD outcomes for payments by a taxpayer that is a dual resident (i.e., where a taxpayer is a tax resident of 2 countries). Both countries are to deny the deduction for the payment to the extent it gives rise to a DD outcome. The rule does not apply to the extent that the deduction for the payment is setoff against dual inclusion income (excess deductions over the amount of dual inclusion income in a current year can be carried forward to set off against dual inclusion income in a future period).

INLAND REVENUE'S 2016 POLICY DISCUSSION DOCUMENT

- 26 The IRD Discussion Document⁴ largely begins with the premise that the OECD rationale for the hybrid mismatch rules is appropriate.⁵ The IRD suggestion is that:
- NZ should largely, without further thought as to the wisdom of the policy from NZ's perspective, adopt the full set of propositions put forward in the OECD Hybrid Report; and
 - NZ's adoption should be comprehensive, rather than specifically targeted at known mismatch arrangements affecting NZ.
- 27 For reasons outlined below, this paper suggests that NZ should reject IRD's proposed approach and should in contrast consider carefully the approach to be taken and:
- be far more restricted in the degree to which the OECD Hybrid Report's proposals are adopted; and
 - for those proposals that NZ does adopt, the law change should be integrated within the NZ current law, and not be a standalone subpart of the statute purporting to override the remainder of the statute.
- 28 Some small attempt is made in the IRD Discussion Document to suggest the possibility of NZ revenue loss from hybrid mismatch arrangements.⁶ A suggestion is made that the *Alesco*⁷ arrangements cost NZ approximately NZ\$300 million in tax and that hybrid entity structures (presumably the reference includes Australian Limited Partnerships structures) result in approximately NZ\$80 million NZ tax lost per year. We will address this in more detail below, but the *Alesco* arrangements almost certainly would have cost NZ no income tax. The NZ\$80 million assessment of NZ tax loss on offshore hybrid entity structures (such as Australian limited partnerships) may indeed be accurate. What that suggests though is a small targeted adjustment to NZ's tax laws—it does not in any sense justify adoption of the full array of changes suggested by the OECD.
- 29 The IRD Discussion Document at paragraph 3.21 purports to show an example of pure economic loss for NZ from a hybrid financial instrument. But the loss identified in that example has already been counteracted and does not arise under the current law by virtue of section CW 9.

4 Policy and Strategy at NZ Inland Revenue *Addressing Hybrid Mismatch Arrangements, a Government Discussion Document* (September 2015). ("IRD Discussion Document")

5 IRD Discussion Document, paragraphs 3.1 to 3.27. Of the 83 page document, 6 pages are devoted to the policy framework issues.

6 IRD Discussion Document, paragraphs 3.17 to 3.21.

7 *Alesco New Zealand Limited v Commissioner of Inland Revenue* (2013) 26 NZTC 21,003.

TWO POSSIBLE APPROACHES TO ANTI-HYBRID MISMATCH RULES: UK "GENERAL PRINCIPLE OVERLAY" OR A "TAILORED" APPROACH

UK "General Principle Overlay Approach"

30 What we describe as the UK "General Principle Overlay Approach" involves the UK's enactment of a separate standalone part (Part 6A) in TIOPA 2010⁸ which largely seems to operate to override the tax consequences that would otherwise arise under the UK tax statutes in the absence of the new Part 6A. Part 6A extends to 68 pages of legislation and is expressed in broad terms along the lines of the principles in the OECD Hybrid Report. In Australia the ATO also seems to support a set of self-contained provisions along the lines of the OECD Hybrid Report. There is an ease to this approach from a perspective of IRD officials:

- little further thought need be given to the rationale for the OECD's recommended changes;
- if anything, the legislation enacted will overshoot rather than undershoot the objectives and may result in double tax;
- problems and difficulties in interpreting the law are left for taxpayers to grapple with, and subsequent legislative corrections can be made where essential; and
- NZ can with ease tick the box as regards the OECD's recommendations and automatically be a fully compliant member of the country club.

Tailored Approach

31 The other approach, which we recommend, is for NZ to tailor its response and, to the extent the OECD's recommendations are adopted by NZ, NZ should deliberately integrate its response into the existing laws. Under this approach:

- NZ is required to make deliberate policy decisions as regards each of the OECD's policy recommendations. For each proposal the Government/Parliament will need to resolve the extent to which it should be enacted by NZ and how best to enact it and fit it into the current legislation; and
- the changes that are made are more likely from the outset to work as intended and be integrated into the NZ Income Tax Act in a way that is capable of understanding by a majority of taxpayers and their advisers.

NZ an early adopter or late adopter?

32 The tailored approach that we suggest is necessarily a tactical response by NZ to the OECD's recommendations that sees NZ able to show that it has "in essence" adopted to a considerable degree the changes suggested by the OECD, while at the same time ensuring that NZ's best interests are served and that NZ's tax system retains its integrity and simplicity as far as is possible. As a tactical response (rather than a tick the box adoption), we suggest NZ be a late adopter, rather than an early

⁸ Taxation (International and Other Provisions) Act 2010 (UK).

adopter of these changes. Having regard to the approaches taken in countries that are NZ's major investment and trading partners will help NZ measure its response.

WHY NZ NEEDS TO TAKE THE "TAILORED" APPROACH

Context: Hybrid Mismatch issues are not a significant threat to the NZ tax base; a tailored response is sufficient

- 33 For proposed tax reform of this scale, it is elementary that the proposed tax reform is able to be justified by an identified threat or identified upside for the NZ tax base. Somewhat alarming is that the IRD Discussion Document does not even seek to identify a NZ tax base issue that justifies implementing proposed hybrid mismatch reforms on the scale suggested (see above).
- 34 Moreover, experience over the last 20 years makes it clear that there is in fact no NZ tax base upside/NZ tax base concern that justifies the proposed hybrid mismatch reforms. Over the last 20 years the only items we have seen that raise NZ tax base issues of the type addressed by the proposed hybrid mismatch reforms are set out below. Further, as we outline below, those issues are capable of being remedied or have been remedied, by tailored legislation/IRD determinations. So in our view it is clear that NZ tax base protection does not warrant an intrusion of anywhere near the scale suggested by the proposed hybrid mismatch reforms:
- **NZ's Conduit Regime:** This was a significant NZ tax base issue resulting from a flawed legislative enactment:
 - (a) The intention of the conduit regime was to relieve tax on CFC income and offshore dividends for NZ holding companies with offshore operating subsidiaries to the extent of non-resident ownership of the NZ holding company. The aim was to reduce the number of NZ holding companies moving offshore as they expanded by raising capital from non-NZ residents, as a result of NZ's overly aggressive CFC regime at that time relative to those of all other countries in the world;
 - (b) One effect of the regime in the way it was enacted was that NZ's banks (mainly Australian owned) were literally allowed to reduce their tax liabilities by borrowing and investing in offshore preference shares issued by offshore financial institutions. This was also allowed to occur in circumstances where tax deductions were available to the offshore financial institutions in the UK/US in relation to the tax-exempt returns they paid to the NZ banks. IRD originally asserted that the reduction in NZ bank tax was intended as a policy matter. Some favourable IRD binding rulings were also issued. Billions of dollars of transactions were undertaken and a number of years later the IRD decided to challenge the transactions under the anti-avoidance regime and IRD succeeded in two High Court judgments (*Westpac*⁹ and *BNZ*¹⁰). The cases were settled before appeals were heard. NZ changed tack, softened the CFC regime with an active business exemption, and the conduit regime was repealed. The issue was removed by tailored legislation;

⁹ *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834.

¹⁰ *BNZ Investments Limited & Ors v Commissioner of Inland Revenue* (2009) 24, NZTC 23,582.

- OCNs:** In recent years a number of NZ subsidiaries have raised capital by issuing optional convertible notes (option for the holder to convert the note into the subsidiary's equity) ("*OCNs*") to offshore parent companies (or associates). Under NZ's financial arrangement rules the OCNs could be on terms that they were interest free and the IRD's promulgated determinations under the financial arrangements rules allowed for notional interest deductions for the NZ subsidiaries. This occurred without any NZ withholding tax, as the financial arrangements rules did not apply to most non-residents. IRD recently succeeded in an anti-avoidance challenge for the notional interest deductions in *Alesco*, even though it is unlikely that in reality this was a NZ tax base issue; if investment had not been by OCN, similar tax deductions in NZ would have been available by a straight debt investment by the foreign parent company. In addition, in certain foreign jurisdictions, Australia being one, the tax laws did not require inclusion of income. Again this was arguably a flawed regime from a NZ tax perspective and has been amended by tailored amendment to the IRD determinations (new Determination G22A creates no phantom interest deductions in wholly-owned group contexts or where OCNs are held pro rata to equity);
- MCNs:** Investments by offshore parent companies/shareholders have also been made by way of mandatory convertible notes ("*MCNs*") into NZ subsidiaries. Again, NZ IRD determinations have allowed interest deductions for interest payments on the MCNs even to offshore parent companies or shareholders holding the MCNs proportionate to their equity investment. A number of offshore regimes (including Australia) have treated the MCNs as equity and allowed exemptions for the interest as exempt dividend income. Again, it is unlikely that there has been in reality a NZ tax base issue with these instruments; given, if not by way of MCN, NZ would have allowed interest deductions to the NZ company for interest expense incurred on straight debt financing. IRD has raised a number of tax avoidance cases involving MCNs, at least one of which has been settled by the taxpayer paying significant amounts.¹¹ Tailored amendment to the IRD Determinations could address this issue if it was viewed as problematic from a tax base perspective (see current Determination G5C);
- Perpetual Debt:** Certain jurisdictions treat perpetual subordinated debt as equity. This allows also for a similar type of arbitrage where NZ allows interest deductions and the investor country may choose to allow tax exempt dividends or foreign tax credited dividend treatment. Other mismatches may rise around debt/equity treatment, i.e. two further examples involve debt issued in substitution/proportion to equity (section FA 2(5), now repealed) and profit-related debentures (section FA 2). These last two are situations where NZ confers/has conferred equity treatment and a foreign country may treat an instrument as debt. Again, these have generally not caused NZ tax base issues because of the operation of section CW 9 (if the foreign country allows a deduction, NZ does not allow the tax-exempt dividend treatment).
- Bank regulatory capital:** It has been reasonably common practice for Australian banks with NZ subsidiaries to raise regulatory capital in ways that achieve tax deductions for interest on legal form debt issued by NZ subsidiaries/NZ branches, but where Australia has treated the instruments as equity allowing Australian franking credits to be attached to dividend

¹¹ See APN News & Media (market announcement found here: <https://www.nzx.com/companies/APN/announcements/284588>)

payments to Australian shareholders for Australian tax purposes. There is real doubt in any claim by IRD that these transactions are negative for the NZ tax base. On their face, the transactions allow interest deductions in NZ within the NZ thin capitalisation constraints for banks and the amount of interest deduction claimed in NZ is reduced because the interest paid is reduced by the benefit Australian investors get from the Australian franking credit. So these transactions are, prime facie, beneficial to the NZ tax base – IRD does appear to seek by contorted analysis to suggest a tax base loss from these transactions. Even if IRD should succeed in convincing Government/Parliament that there is a tax base loss from these transactions, action can again be by way of tailored legislation rather than the proposed hybrid mismatch reforms (we note that even in the UK/Australia, which are pursuing the proposed hybrid mismatch reforms, they are carefully considering the degree to which the reforms should apply to bank regulatory capital);

- ***Australian limited partnerships and dual use of interest deductions:*** The use of Australian limited partnerships by NZ parent companies to make investments into Australia in ways which give rise to interest deductions on debt finance being available in both Australia and NZ does appear to be a genuine NZ tax base issue. There are existing rules that protect against some importing of tax losses from offshore (see for example, CFC loss quarantining rules and section IC 7 rules preventing loss offset by a company treated as tax resident of another country). If there is a desire to protect against this issue, tailored legislation can be enacted. Again, this does not justify the full scale of the proposed hybrid mismatch rules.

35 As we have suggested, none of the above examples demonstrate a NZ tax base issue that justifies from NZ's prospective introduction of the UK General Principle Overlay Approach to the proposed hybrid mismatch rules. The only example we have identified as a genuine NZ tax base issue is the Australian limited partnership. Our view is that this, and any other issue considered problematic, can be addressed by a tailored solution.

36 We are also aware of a variety of mechanisms for non-NZ tax reduction in the context of acquisitions of NZ businesses. These include use of unlimited liability companies/branches as a mechanism for flow through to foreign tax jurisdictions (in particular the US) of interest deductions from acquisition debt raised in NZ to finance NZ acquisitions. But these do not raise NZ tax base issues. Rather, in these types of cases, the introduction by NZ of the proposed hybrid mismatch rules can only be justified as a mechanism for foreign tax base protection which we address further below.

Context: The “a plague on all your houses” rationale is not appropriate and does not justify the General Principles Overlay Approach in NZ

37 Discussions with IRD officials suggest that from an international perspective there is a measure of “utu” (revenge/payback) for international corporate behaviour that underlies the rationale for the OECD BEPS Project generally and, in addition, the proposals in the OECD Hybrid Report. Tired of continually being a step behind the intricate schemes of multinationals and their tax advisors, the proposals in the OECD Hybrid Report are intended to be designed so that, irrespective of how a taxpayer tries to get to the end result of tax reduction by a D/NI mismatch, their efforts are defeated by the new rules.

38 With that emotional style of rationale in support, the suggestion from officials is/might be: "don't talk to us about the impossible complexities of these rules and the increased compliance costs, you (the multinational corporates) have brought those on yourselves."

39 Even accepting the likelihood that there is a measure of truth in this in the European/US contexts, in our view the NZ experience does not in fact justify this response. That this is the case is evident from the real difficulty in identifying any significant systematic NZ tax loss from the types of transactions targeted by the OECD Hybrid Report.

Context: The "no go" zones rationale is not an appropriate rationale in NZ

40 The idea that the rules are deliberately complex/ virtually incomprehensible at the level of specific implementation and are designed to just create "no go" areas is in our view simply not a plausible proposition. This is because the rules cover potentially such a wide array of commercial activity that they simply cannot all be packaged up and placed in a "no go" area:

- Differing tax treatments between countries of branches/permanent establishments and limited partnerships bring the rules into play;
- Cross-border acquisitions with deferred purchase prices are potentially subject to this regime;
- Repurchase transactions/short sales and equity securities lending transactions are within the regime. In international markets there will be billions/trillions of dollars in the transactions, much of which will not be tax driven; and
- Bank regulatory capital raising may be within the regime.

41 It is not plausible to suggest that the rules in these areas should be deliberately complex/virtually incomprehensible at the level of implementing specific transactions so as to create "no go" areas in these zones. Indeed even in the UK/Australia context specific exceptions are being considered for bank regulatory capital raising and modest repo and short sale/securities lending transactions by traders i.e., the UK/Australia are prepared to tailor their response according to their economic interests.

Context: Limited to Intra Group Transactions and "structured arrangements" (i.e. tax avoiders)

42 We accept that, prima facie, the OECD Hybrid Report rules appear to be directed at broadly the correct target—being controlled groups of companies (who do have control of the full set of transactions that they enter into) and "structured arrangements" generally to which a taxpayer is a party. For this purpose, a taxpayer will not be party to a "structured arrangement" if it could not have been reasonably expected to be aware of the hybrid mismatch *and* did not share in the value of the tax benefit resulting from the hybrid mismatch. However, while aimed at the correct target, we can foresee significant issues for companies on audit (even if no evil being evident).

43 First, as regards the hybrid financial instrument rule, the OECD Hybrid Report suggests that parties do not need to be in a "control group," they simply need be

“related parties:” this is a lower 25% threshold for association particularly when aggregation rules are considered.

- 44 Secondly, the objective test for “structured arrangements” means that there is a real risk of overreach. Given the rigorous nature in which tax authorities conduct audits, taxpayers may face considerable costs when faced with an allegation by tax authorities that the taxpayer knew or “could reasonably have been expected to be aware” that a hybrid mismatch existed. Further, demonstrating that a taxpayer did not share in any of the tax benefits arising from the hybrid mismatch may be an expensive/complicated process requiring specialist investment banking advice. This test creates an opening for tax authorities to deploy considerable pressure and extract payments by way of settlement in order to bring a tax dispute process to an end.

Context: NZ should not adopt the mind-boggling complexity/uncertainty created by General Principle Overlay Approach

- 45 Our attempt at a simple outline of the recommendations in the OECD Hybrid Report cannot fully disguise the scale of the complexity that is involved. The Report is more than 450 pages of text, with 300 of those pages dedicated to 80 examples. To give some sense of this, working with one of NZ’s top tax policy officials, our Chapman Tripp tax team had the pleasure of spending around 2 hours debating just one of the examples. At the end of that time there was no consensus as to whether the result in the example was correct; and this is before there is any legislation (to those who are tax practitioners, the language of the legislation often obscures, rather than clarifies, the principles). We discovered that even assessing whether a D/NI result occurs is intricate, given that NI arises when an item is not included in “ordinary income” as defined (a definition which excludes income benefitting from an exemption; exclusion; credit or other relief).¹²

- 46 The complexity includes:

- The revolution of having NZ’s tax treatment of a broad array of transactions turn on the tax treatment of the transaction in one or more other countries under their foreign law. The NZ tax treatment may turn on tax treatment in multiple countries, not just the treatment in one other country; consider for example Recommendations 4 (reverse hybrids) and 8 (imported mismatches). (Many object to this approach on the grounds that it undermines a country’s national sovereignty as regards the imposition of taxes.)
- Where there is uncertainty in the foreign tax laws as to the outcome (whose tax law is after all certain in its scope?), that foreign tax law uncertainty is, under the OECD Hybrid Report approach, imported into the NZ law results. As a practical matter in the context of tax audits being run by two or more countries, current tax disputes practices do not allow for the tax administration in one country to resolve its tax position having regard to the outcomes of a determination of the tax position in another country. For example, if interlinked tax systems of the type envisaged in the OECD Hybrid Report are to be adopted worldwide, it would seem essential for there to be special mechanisms to allow for integration of tax disputes in relation to the application of those rules under the domestic tax laws in each country. The tax treaty dispute resolution mechanisms (themselves not very effective) do

¹² See OECD Hybrid Report, paragraph 42.

not even apply in the context of interlinked domestic tax law disputes under the OECD Hybrid Report proposals. No such mechanism has yet been suggested. What might be necessary are delays in domestic tax dispute timing rules and an expanded ability to reopen tax returns (to allow the domestic effect of subsequent foreign law determinations to be taken into account).

- Although the OECD Hybrid Report suggests a series of principles, it leaves each country to adopt rules for their own tax systems. Each country therefore selects its own form of enactment, in its own language, and with its own exceptions. Even if all countries embraced the OECD Hybrid report fully (which they do not), there would be no reality to the idea that all countries would be enacting the same thing.
- Ongoing changes in the tax laws of other countries would affect NZ tax results. So as regards multi-year transactions, the requirement to take account of foreign tax laws in determining NZ tax treatment is an ongoing one which needs to be updated as foreign tax laws change.
- Use of the “General Principle Overlay Approach” would add to the complexity in terms of determining the practical effect of the rules enacted. It seems obvious and elementary that if the NZ legislature enacts tax legislation it should have considered and understood its scope and effect, and affirmatively have chosen to enact the legislation understanding its consequences. It had not occurred to the authors of the OECD Hybrid Report, for example, that the reverse hybrid rule would apply to NZ’s foreign trust regime. Now it is a good thing that IRD have focussed on this possibility; otherwise, simply enacting the OECD Hybrid Report on a general principle overlay basis, without any further thought, would have had the effect that NZ’s foreign trust regime would have been effectively repealed without the legislature even knowing that this was what it was doing. This would have been the case even though the Shewan report on NZ’s foreign trust regime (concluded only in July 2016) took the view that no NZ taxation of foreign source income of a foreign trust under the existing law was an appropriate policy setting.¹³ We suggest the tailored approach to ensure that other inadvertent changes in tax settings do not occur without thought.

47 Clearly this interaction of NZ law with foreign laws will dramatically increase the compliance costs for taxpayers—not only will taxpayers now require specialist tax advice from foreign jurisdictions to determine how NZ’s own laws will apply to their potential deductions, the advice requires knowledge of the tax outcomes and tax filing positions for counterparties who may, especially in the context of “structured arrangements” between unrelated parties, have no shared interests and no desire to disclose such information. Moreover, in “structured arrangements” the suggestion may well be that a counterparty needs to warrant its foreign tax treatment and, if this proves to be incorrect and causes NZ tax loss, the foreign counterparty should indemnify the NZ counterparty for the NZ tax loss. This would overthrow norms of international risk allocation. If a foreign counterparty is not prepared to take an NZ tax risk, the NZ counterparty is left bearing NZ tax risks that turns on foreign tax treatment but without assurance as to the accuracy of the foreign tax treatment on which the NZ tax position relies.

¹³ John Shewan *Government Inquiry Into Foreign Trust Disclosure Rules* (New Zealand Government, June 2016), at paragraphs 4.18 and 13.25-13.28.

48 We do not necessarily expect mind-boggling complexity to stop the OECD Hybrid Report proposals in their tracks in NZ. We anticipate that more will be required by Inland Revenue before a tailored approach will be taken in NZ. But NZ is too small to ignore the costs of complexity. As Lee Sheppard observes in a 2015 Article:¹⁴

“Why do Americans have such an appetite for complexity? Americans don’t have to think about systemic administrative costs. ... The United States is a very large country, with a very large economy, so administrative costs that would kill a smaller country are a pinprick on a rhinoceros hide”.

49 In this context, it is self-evident that NZ is not a rhinoceros (noting also that it appears that the US itself will not adopt the OECD Hybrid Report proposals).

Context: NZ needs to recognise the flawed foundations of the Anti-Hybrid Mismatch Proposals

Not all countries will be in

50 A basic tenant of the ‘country club’ rationale is that all nations, particularly those for whom the rules were primarily developed, must actually be implementing the rules themselves. Without this global commitment, there is no justifiable reason why NZ should bear the implementation costs, compliance costs and complexity of a regime that benefits other nations if other beneficiaries will not share in that same burden. Though the IRD Discussion Document shows the NZ Government’s “expectation that [other] countries that are part of the consensus will act,”¹⁵ a survey of other nations shows that this is not likely to prove entirely accurate:

- Early adoption is currently spearheaded by the UK, having already enacted anti-hybrids legislation that will be effective on 1 January 2017.¹⁶ While the UK is adopting almost the full spectrum of complicated rules, this is arguably justifiable given the potential scale of hybrid abuse in the UK. Notwithstanding these problems, UK has targeted exemptions for regulatory capital,¹⁷ stock loans and repos which will largely reduce the impact of these rules on its banks and financial traders, despite the likelihood that those groups are key beneficiaries of hybrid mismatch arrangements.
- Though without publishing any actual legislation, Australia has also made significant progress towards adopting anti-hybrid measures. From its public consultations, we expect that Australia will adopt versions of OECD’s recommendations to be effective no earlier than 1 January 2018. Importantly however, Australia also proposes to modify OECD’s recommendations where

14 Lee A. Sheppard, “BEPs Action 2(Hybrid mismatches), The Hybrid Hydra” (October 2015), Tax Notes International.

15 At 1.11.

16 Schedule 10, Finance Act 2016 c.24 (UK).

17 Despite indications from the UK that its exclusion of regulatory capital is a temporary measure there is no certainty that regulatory capital will ever be included in a meaningful fashion, given that UK’s earlier intentions to include it (see HM Treasury “Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements” (December 2014)) were successfully blocked by the industry.

necessary to advance its own interests.¹⁸ Australia may also exclude regulatory capital.¹⁹

- The EU also intends to implement anti-hybrid legislation, having proposed two council directives that address hybrid mismatches in the context of broader tax reforms. EU measures differ depending on whether the mismatch occurs between two EU member states or an EU member state and a third party:
 - (a) The directive to address hybrid mismatches between EU members is effectively a restatement of the primary rules contained in Recommendations 1, 3, 4 and 6, i.e. member states are instructed to deny deductions for payments made in the presence of a DD or D/NI outcome.²⁰
 - (b) In contrast, the directive to address external mismatches requires the implementation of both primary and secondary rules which includes the imported mismatch rule.²¹
- EU's proposals require EU member states to introduce domestic law by 31 December 2018 to give effect to the directive. Given the differences between each member's tax systems and intra-EU competition for inbound investment, one should not expect complete uniformity between the approaches of member states.
- China indicated an intention to introduce anti-hybrid rules in 2015, but we have not identified any publically available English guidance on what form these rules may take. However, fully-fledged implementation is unlikely as hybrid instruments in China are already curtailed to a large degree by its capital and foreign exchange controls.²²
- Though US "check-the-box" rules are likely the largest facilitator of hybrid mismatch arrangements in the world, it seems likely that the US will only adopt token anti-hybrid measures, if any (President-elect Trump and Republican majorities in both the Senate and the House are not likely to lead to broader adoption of anti-hybrid measures by the US, but stranger things have happened!).²³ Consequently, Canada is also unlikely to adopt any meaningful anti-hybrid measures because it will not risk placing its multinational companies at a competitive disadvantage to those in the US.

18 Limited reverse hybrid rules (no Recommendation 5); no limit for relief on foreign withholding tax (no Recommendation 2.2); potentially excluding the imported mismatch rule (Recommendation 8).

19 AT Board was due to report back on regulatory capital by the end of July 2016 but had not done so at the time of writing.

20 Article 9: Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the market (COM (2016) 26 Final).

21 Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (COM (2016) 687 Final).

22 KPMG "China – response to BEPS" (2 June 2016) KPMG <<https://home.kpmg.com/xx/en/home/insights/2016/06/beps-action-plan-china.html>; <http://www.internationaltaxreview.com/Article/3511704/China-at-the-forefront-of-global-BEPS-implementation.html>> (accessed October 2016).

23 Powerful members of the US legislature such as Senator Orrin Hatch (Utah) and Speaker Paul Ryan (Wisconsin) are publically opposed to any BEPS initiative that could potentially detriment US taxpayers and have stated that the US "shouldn't be negotiating agreements that undermine our own interests for the sake of some supposedly higher or nobler cause. The interests of the United States – our own economy, our own works, and our own job creators- should be our sole focus."

- At the time of writing, no concerted initiatives had been reported for Singapore or Japan.²⁴

51 Although the rules have been designed to allow for the possibility of non-adoption by all countries, in the present context it would be naïve for NZ simply to adopt a UK General Principle Overlay Approach without more thought. In our view, a tailored approach is required.

Tax Havens are protected; imported mismatch rules problematic

52 As a general rule, the OECD Hybrid Report proposals do not attack tax advantages from, for example, paying tax deductible payments from companies in high-tax countries as income to companies established in tax havens or low-tax countries. Broadly, it is only tax reduction by virtue of the hybrid nature of the instrument or the hybrid nature of the entity that is targeted (although there is room under the regime for technical foot-faults that produce increased tax liabilities).

53 In this sense, tax havens/low-tax countries can be regarded as protected and encouraged by the OECD Hybrid Report. In our view, this state of affairs seriously undermines the integrity of what is being done. By not addressing the tax haven/low-tax question, the OECD Hybrid Report proposals may prove to be largely ineffective in taxing returns on multi-national capital flows. To some considerable extent it can be predicted now that in 10 years' time these rules may have proven to be largely ineffective in raising increased tax on returns on capital flows. How will governments and the public view the outcome if, for all this complexity/ compliance cost, there is no significant benefit in terms of taxation of returns on capital flows?

54 That result may well happen because nothing is done to attack investment in straightforward debt instruments from low tax/territorial tax jurisdictions (e.g. Ireland/Switzerland/Singapore/Hong Kong). So the corporate response can be expected to capitalise more and more treasury operations based in those jurisdictions. It can also be anticipated that over time an increasing number of countries will operate a territorial or low tax regime to attract this type of activity. In this paradigm, clearly high value jobs will increasingly locate in those jurisdictions who use their tax system to attract this type of activity:

“Planners are responding to European countries’ efforts by using plainer debt instruments under which payments are made to low-tax jurisdictions. The BEPS report is not an anti-conduit effort. It does not cover back-to-back loan schemes that do not involve hybrids. And it doesn’t ask questions about the tax rate imposed on a deductible item as long as the payee has to recognise it under local law”.²⁵

This likely ineffectiveness is one factor to be taken into account in our conclusion that the tailored approach is appropriate.

55 In principle we object to the imported mismatch rule on the grounds that it has the potential to have a negative impact on NZ’s attraction of FDI. We also make the point also that the imported mismatch arrangement rule seems to have a real problem in terms of the integrity of what is being done. The report suggests that

24 Deloitte “BEPS Actions Implementation Matrices” Deloitte <<https://www2.deloitte.com/global/en/pages/tax/articles/beps-action-implementation-matrices.html>> (accessed October 2016).

25 Lee A. Sheppard, “BEPS and EU Progress Report” (June 2016) Tax notes International at 1217.

this rule should only apply where the funds can be traced from the hybrid mismatch to the country that is importing the mismatch. Consider Example 8.1 (page 341- 3 and in particular paragraph 8 of the Example; an extract of which is included as Example 4 in the Appendix to this article). An approach that depends on “tracing” of funds through multiple layers higher up in a multinational is most unlikely to be effective — it requires mass tracking of all intragroup transactions much higher up in a corporate chain to determine whether interest deductibility in NZ is allowed; while at the same time allowing anyone who wants to avoid the rule to avoid it by setting up a fungible treasury function at some point in the chain between NZ and the higher tier hybrid financial instrument that breaks the “tracing” chain required before the rule can operate. If there is to be an exclusion where there is an inability to trace, the rule will not be effective and in our view should not be adopted in the first place. The fact that an exclusion of this type is contemplated strongly suggests that the proposal had a significant degree of overreach from the outset.

Country Club to protect other countries’ perceived aggregate interest vs NZ’s interests

- 56 That the whole rationale for the hybrid mismatch payments rules is highly questionable can be seen from a simple example in two real life scenarios:
- (a) Assume Australia is, in relation to regulatory capital instruments, to allow franking credits to Australian investors for franking credits attached to payments that are treated as tax deductible interest payments from NZ branches of Australian banks. If that is the case, what purpose is NZ achieving by enacting the hybrid financial instrument rule? If Australia affirmatively chooses not to counteract the tax benefit on these instruments, what is NZ acting to protect when it deploys the hybrid instruments rule to deny the interest deduction in NZ? Note in particular that availability of the franking credits actually reduces the interest paid to the Australian investor and therefore reduces the interest deduction against the NZ tax base that would be claimed if Australian franking credits were not allowed in Australia.
 - (b) To similar effect, what purpose is NZ achieving if NZ deploys the hybrid instruments rule to deny a deduction in NZ for a payment treated as interest expense by NZ in respect of a foreign investor located in a country that treats the payment as a dividend and which has deliberately chosen not to adopt the rule in Recommendation 2 (i.e. has chosen not to adopt a rule the equivalent of NZ’s section CW 9(2)).
- 57 We find these questions particularly difficult to answer. Given that Australia/the foreign country has deliberately chosen not to act in conformity with the OECD Hybrid Report proposed rules, NZ’s denial of interest deductions in the examples clearly would not be advancing Australia’s/the foreign countries’ perception of its own interests. In this case, it seems that NZ is supposed to act to deny tax deductions on what NZ sees as legitimate interest expense because of some broader bond to support the interests of a broader “country club” beyond the counterparty country. NZ offers to step into the breach to honour the interests of the “country club” even though the counterparty country has deliberately chosen not to support the “country club”. Really??
- 58 Professor Graeme Cooper suggests a slightly different, but similar, issue with the OECD Hybrid Report rule:

“One remarkable, but unstated, implication arising from [the OECD Hybrid Report rules] ... is the conclusion that these rules are attempting to ensure all income must be taxed at least once, but it does not matter where. Whether the tax is collected under the response rule or the defensive rule is immaterial. Indeed, the positions expressed in the six rules are not reached on the basis of any overarching principle. The Recommendations Paper deliberately avoids any attempt to determine which state has lost revenue and which state should benefit by a greater revenue collection. Consequently, which state ultimately collects revenue from implementing the recommended rule could be arbitrary or driven by strategic behaviour.”²⁶

- 59 He understandably views this as at odds with the BEPS mantra that profits should be taxed “where the economic activities that generate the profits are performed and where value is created.” He also raises, and we agree with, the oddity of the constant use in OECD Hybrid Report proposals of denial of deductions as the solution to all hybrid problems, even if they are driven by something other than a deduction.
- 60 Where a country does not introduce the rules at all, or only implements certain rules, or chooses to leave holes in its rules, NZ needs to recognise that adopting every recommendation in the OECD Hybrid Report will result in the entire increased tax impact of the rules occurring in NZ (and not in the foreign counterparty country). NZ needs carefully to consider the economic consequence of that tax impact. In these circumstances, it simply cannot be that NZ blindly adopts the full rules without question.

Double tax is imposed

- 61 Oddly, although seeking to eliminate double non-taxation, the OECD Hybrid Report proposals result in imposition of double taxation in a number of situations. For instance, in Example 3 in the Appendix the interest deduction is denied to B Co even if A Co is paying tax on the sales process. Similarly, the proposals promote double taxation by ignoring withholding taxes in determining whether a hybrid mismatch arrangement produces a D/Ni outcome, i.e. the OECD Hybrid Report rules might apply to treat a transaction as producing a Ni result, even where source country withholding tax is imposed (withholding rates under domestic law can be as high as 30%). The OECD Hybrid Report explains the rationale for this as follows:

[at 407] “The function of withholding taxes under the laws of the payer jurisdiction is generally not to address mismatches in tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source.”

- 62 The logistics of tax disputes in two different countries also create a significant risk of double taxation for corporate groups—resolution of uncertainty in one country may not come in a timely manner for another.
- 63 The logic of the framework is called into further question because, even where the OECD Hybrid Report rules actually operate to deny a deduction for interest expenses, the OECD still suggests that the payments be treated as interest for the purposes of imposing withholding tax (i.e. as if the deduction had not been denied). The NZ Government suggests that this approach be accepted at paragraph 11.4 of the IRD Discussion Document.

²⁶ Graeme S. Cooper “Some thoughts on the OECD’s recommendations in Hybrid Mismatches” (July 2015) Bulletin for International Taxation.

Context: NZ's policy to attract FDI requires the Tailored Approach

NZ Government policy seeks to attract additional FDI

- 64 Current NZ Government policy announced in July 2015 seeks to attract increased FDI under a new NZ Investment Attraction Strategy. An extract from the Cabinet Paper approving the strategy states the principles and sets a clear target as follows:

"Achieving the government's goal of building a strong competitive economy with increasing numbers of higher paid jobs will require ongoing significant increases in business investment, and international investment will be an important source of capital to fund this increase. High quality international investment will assist with increasing exports to 40 percent of GDP, help lift research and development intensity to one per cent of GDP, and bring additional benefits to the economy. We have not yet been as effective as we can be in attracting the type of high quality international investment we need.

...

Theme 1: attract high-quality foreign direct investment in areas of competitiveness for New Zealand

...

Target

We propose the target for theme 1 be to facilitate investments with a potential direct economic impact of \$5 billion over three years."

- 65 Moreover, the FDI piece is part of a broader integrated framework that includes attracting overseas investment in R&D and attracting entrepreneurs to reside in NZ. This strategy was stated to be based on "an aligned, whole-of-government effort to attract high-value FDI".
- 66 This strategy is consistent with economic research that shows that FDI brings benefits to a country: it creates economic growth, increases jobs, lifts productivity and also provides access to new ideas and technology.²⁷ In contrast, a lack of FDI may result in increased interest rates, reduced consumer spending and eventually, reduced employment.
- 67 So any proposed adoption of the OECD Hybrid Report proposals must first address carefully the question of potential adverse impact on the existing NZ Government policy under which NZ seeks to attract more FDI.
- 68 The IRD Discussion Document does not address the consequence of adopting the OECD Hybrid Report proposals for NZ's FDI attraction strategy. The draft IRD tax framework for inbound investment (June 2016) at least begins the discussion:

"An important priority for the future will be to consider measures to address BEPS. This includes consideration of rules to address hybrid mismatches and the possibility of tighter interest limitation provisions. When addressing these

²⁷ NZIER *Foreign Direct Investment in New Zealand: A brief review of the pros and cons* (NZIER, March 2016) at 3; MBIE *Business Growth Agenda: New Zealand Investment Attraction Strategy* (MBIE, 2015).

issues the focus will be on doing what is in New Zealand's best interest but, at times, this may mean co-operating with other countries to achieve a more efficient worldwide outcome and seeking to gain our share of a bigger worldwide pie."²⁸

69 Indeed, the IRD paper confirms the need for careful testing of each of the BEPS initiatives, including the OECD Hybrids Report proposals:

"Each [BEPS initiative] needs to be looked at critically from New Zealand's point of view."²⁹

International tax competition and sensitivity of FDI to tax; adverse impact on NZ FDI attraction of OECD proposals

70 We do not address here the detail of the tax framework as regards FDI. Although increases in effective tax rates do not have a perfectly linear relationship with reductions in FDI, OECD studies nevertheless conclude that for every 1% increase in effective tax rates FDI will be reduced by 3.75% on average.³⁰ There is therefore legitimacy to the proposition that NZ seeks to attract FDI in a context of international competition as regards taxation on FDI. IRD's commentary acknowledges the relationship between tax levels and FDI generally.³¹

"Taxes can have important effects on the incentives for non-residents to invest in, or lend money to, NZ... Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to NZ."

71 The existence of economic rents (foreign investors who need to be in NZ to make their profits and are therefore less sensitive to NZ taxes) and foreign tax credits for offshore investors in their home jurisdictions mean that it is difficult to assess with precision the impact of NZ taxes on the ability of NZ to attract FDI. We believe that the type of marginal increase in FDI that the NZ Government seeks to attract under its new policy is likely to be more sensitive, rather than less sensitive, to the imposition of NZ tax. This FDI is not occurring naturally in NZ now so it seems to us less likely that this FDI falls into the economic rents category. If that assessment is accurate then NZ needs to take particular care as regards the potential for adverse effect on NZ FDI attraction from introduction of the OECD Hybrid Report proposals.

72 Current FDI into NZ arises as follows:³²

Country	FDI in 2016	Total NZ FDI (% of total)	Position as regards OECD Hybrid Rules?
Australia	\$537m	\$50,659m (51.5%)	Yes

28 Policy and Strategy at NZ Inland Revenue *New Zealand's taxation framework for inbound investment: a draft overview of current tax policy settings*, (June 2016) at page 26; and see pages 20-22.

29 Ibid 28, at 22.

30 OECD *Tax Effects on Foreign Direct Investment* (2008) Policy Brief. See generally IRD June 2016 draft overview; OECD – Executive Summary of Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis (2007); NZ Tax Review 2001 Final Report, at page 20-21,75-83 and Annex E at 133.

31 Ibid 28, at 3.

32 NZ Trade & Enterprise Statistics <www.nzte.govt.nz/en/invest/statistics/> (accessed October 2016).

United States	\$100m	\$7,686m (7.81%)	Unlikely
Singapore	\$418m	\$5,651m (5.74%)	Unknown
Hong Kong	\$109m	\$5,503m (5.6%)	Unknown
United Kingdom	\$-956m	\$5,367m (5.45%)	Generally yes
Canada	\$339m	\$4,275 m(4.3%)	Unlikely
Netherlands	\$718m	\$4,235m (4.3%)	Likely yes (EU)
British Virgin Islands	\$3,009m	\$3,009m (3.06%) (Assumed from other countries—UK?)	Unlikely

- 73 Also of relevance are expectations as to the countries from which future FDI into NZ is expected to originate. Given expanding trade relationships with the Asian region, it seems quite plausible that FDI into NZ from the Asian region may over time increase in significance.
- 74 In assessing the significance of Australia's FDI into NZ (51.5% of the stock of FDI) and the extent of Australia's adoption of the OECD Hybrid Report proposals, it needs to be observed that the vast majority of Australia's FDI is in the financial and insurance sectors (76% in 2012)³³. In this regard NZ needs to be close to the Australian position on application of the OECD Hybrid Report proposals as regards bank/ insurance company regulatory capital (this is still under review in Australia).
- 75 Important for any foreign investor is understanding NZ's effective tax rate on their investment. This is an average of the effective NZ tax rate on equity investment (28% corporate tax rate) and the effective NZ tax rate on any related party debt investment (generally 10% NRWT on related party interest and a 10% limit under the relevant NZ tax treaty, assuming deductibility in NZ of interest on the related party debt). NZ's thin capitalisation limit constrains total debt financing including both related party debt and non-related party debt (generally to 60% of total assets).
- 76 Critical then to FDI investors is for them to understand in particular the extent to which they are able to deduct interest on related party debt. It is here that NZ adopting the OECD Hybrid Report proposals becomes problematic from the non-NZ investor's perspective.
- 77 For example, assume for the moment that the USA/ Canada/ certain Asian countries do not adopt the OECD Hybrid Report proposals. If NZ does adopt the OECD Hybrid Report proposals in full, non-NZ investors from those countries face the possibility that NZ interest deductions in relation to related party debt may be denied (and their after tax returns reduced) in circumstances where:
- the related party lending to the NZ entity/ branch is by way of a hybrid financial instrument (e.g. MCN) that otherwise produces a D/Ni outcome (this is the result of Recommendation 1 where the country of residence of the investor has not adopted Recommendation 2, for example the country of residence of the investor does not prevent a tax exemption for the payee where interest payable on the MCN is tax deductible to the payer);

³³ Statistics New Zealand <http://www.stats.govt.nz/tools_and_services/newsletters/economic-news/may-13-direct-investment-with-australia.aspx> (accessed October 2016).

- interest on the related party lending is paid to an offshore hybrid entity or reverse hybrid entity, in which case issues as to interest deductibility in NZ may arise under either Recommendation 3 or Recommendation 4; or
- the related party lending is linked under the imported mismatch rules to a hybrid mismatch higher in the corporate group.

- 78 How then will those investors evaluate NZ as an investment destination? One thing is sure—they will need to understand the nature of any risk they have that interest expense that they are expecting to be tax deductible in NZ may in fact prove to be non-deductible. This is potentially of direct and immediate importance to the investor's after tax returns. If all the world adopted the proposals on identical terms then the risks and compliance costs of the OECD proposals could be expected to be similar for all investment destinations and NZ's adoption should not in that case be problematic in terms of FDI attraction.
- 79 But our example presumes what is likely to be the reality: that USA/ Canada and significant parts of Asia do not adopt the rules at all or do not adopt the rules in full. If this is the case then investors from those countries will have options to invest in countries other than NZ where they are not subject to the risks of reduced after tax returns (by elimination of the benefit of arrangements that are available to produce lower tax imposts for returns on their investment or the risk of such an adverse outcome) and where they are not subject to the compliance burden of trying to ensure that the OECD rules in fact do not harm. We see real potential for adoption by NZ of the OECD rules to adversely affect the NZ Government's policy of attracting FDI from investors in those countries.
- 80 There seems to be more complexity in assessing the relative position of investors from countries that adopt the OECD Hybrid Report proposals when comparing investment in: NZ (if it adopts the OECD proposals); and investment in another country where the proposals have not been adopted. Critically this will also depend on whether the investor country has also adopted the secondary defensive rules. But what is clear is that the non-adopting country into which the investor may invest will be a far simpler proposition from the perspective of the investor determining their tax liabilities than New Zealand will be if it adopts the OECD Hybrid Report proposals in full. In particular, the investment into the non-adopting country by the non-NZ investor will not have interest deductions potentially denied under the hybrid financial instrument rules, the disregarded payment by a hybrid rule, the payment made to a reverse hybrid rule or the imported mismatch arrangement rule; and the investor into the non-adopting country will not have to deal with the compliance burden of the OECD rules in calculating its non-adopting country tax liability.
- 81 Whether a lower tax in-country burden for the investor in a non-adopting country transforms into higher after tax returns (including investor country tax) for the investor is another issue and is dependent on the way in which the investor structures its investments and the degree to which the investor country adopts the OECD recommendations. Some of the OECD rules have secondary responses that are relevant to the investor in the case of investment in non-adopting countries and they may trigger tax liability in the investor's country of residence (for example as regards hybrid financial instruments and disregarded payments made by a hybrid entity, the secondary responses in the OECD rules adopted by the investor country may trigger a tax liability for the investor in its country of residence). But for some of the other rules there is no secondary response (for example there is no secondary rule for imported mismatch arrangements and none for payments made to a reverse

hybrid—see generally the chart at page 20 of the OECD Hybrid Report for a useful chart providing an overview of the proposals). So in these types of cases where there is no secondary rule (and if the investor country has not adopted other suggested OECD amendments to buttress its offshore tax regime):

- an investor group investing in the future into an NZ that adopts the full OECD Hybrid Report proposals may have significantly higher tax costs in NZ than they would do if they invested in the non-adopting country; and
- those lower tax costs for the investor group in the non-adopting country may well produce higher after tax returns to the investor group, even after taking account of investor taxes. This because, even though the investor's country of residence has adopted the OECD Hybrid proposals, those proposals do not, as regards the three rules identified, have secondary responses that affect the investor's tax liability in its country of residence.

Preliminary thoughts on the tailored approach NZ should take

82 This paper advocates for New Zealand to take a "tailored" approach to the OECD Hybrid Report proposals. Under this tailored approach:

- NZ should reject any presumption that, without the need for further thought, the UK General Principle Overlay Approach should be adopted;
- NZ should make deliberate policy decisions in NZ's interest as regards each of the OECD policy recommendations and the extent to which each is adopted by NZ. To the extent the OECD proposals are to be adopted, specific new rules should be integrated into the existing statute (not served up as a stand-alone overriding subpart of the statute);
- some of the OECD Hybrid Report proposals should not be adopted at this time. At this stage our view is that rules that deny to foreign direct investors NZ interest deductions which would otherwise be allowed within NZ's existing framework should not be adopted and this would include the imported mismatch rule/ the rule as regards disregarded payments by hybrid entities and the rule as regards payments made to a reverse hybrid.

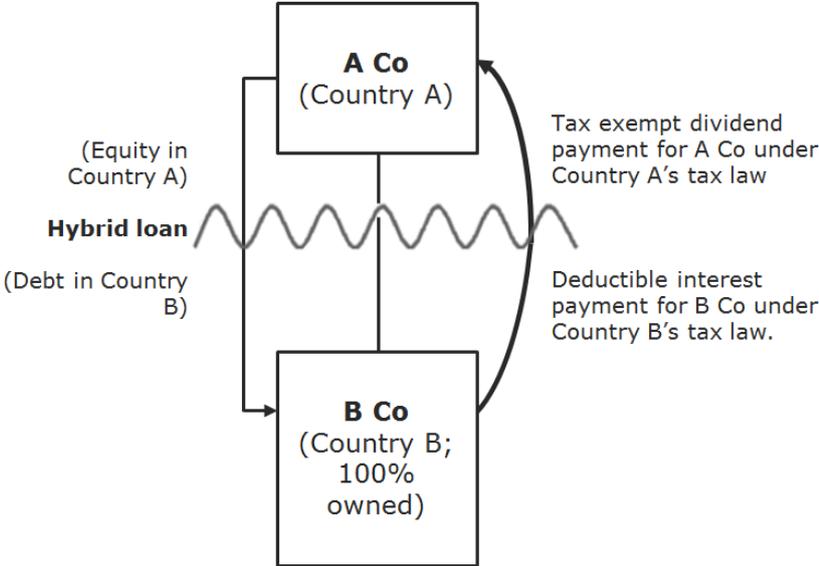
83 The compelling reason for the suggested "tailored" approach is that adoption of the UK General Principle Overlay Approach, without further thought, would potentially have a significant adverse impact on the NZ Government's current policy emphasis on attracting more foreign direct investment into NZ. We believe that this issue has not yet been fully analysed and that the analysis needs to be undertaken and fully tested before adoption of the OECD Hybrid Report proposals by NZ.

84 In addition to the difficulties that the OECD proposals cause as regards attraction of FDI, we remain concerned that in a number of respects that we have outlined above the principles underlying the OECD proposals are flawed.

APPENDIX: FOUR EXAMPLES OF THE OECD HYBRID REPORT RULES IN ACTION

The following four examples are taken from the OECD Hybrid Report (here conclusions are just summarised; full analysis is available in the report).

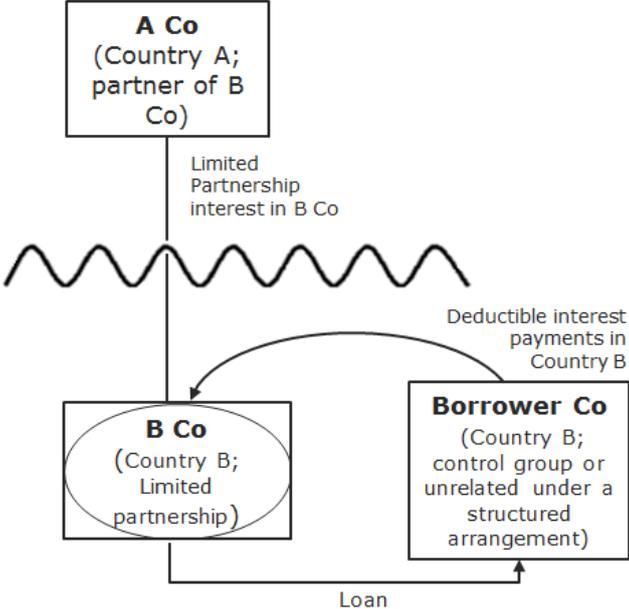
Example 1: OECD Hybrid Report Example 1.1 (page 175) – Interest payment under a debt/equity hybrid



If Country A treats the payment from B Co as a tax-exempt dividend (i.e. Country A does not adopt Recommendation 2 of the OECD Hybrid Report and does not have a rule equivalent to NZ's section CW 9(2)), Country B would apply the hybrid financial instrument rule to deny B Co's interest deduction.

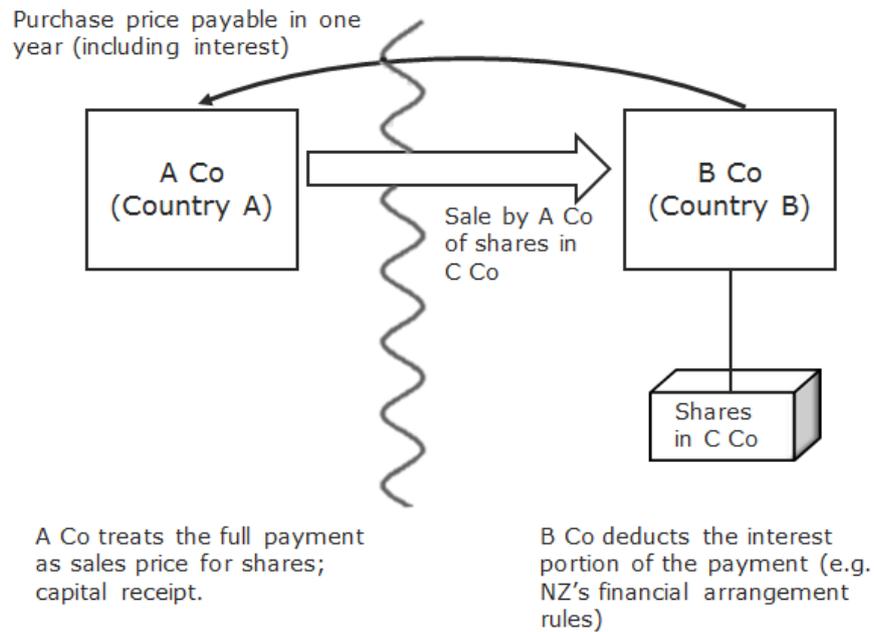
If Country A adopts into its domestic law Recommendation 2 of the OECD Hybrid Report (i.e. a rule equivalent to NZ's section CW 9(2)), Country A would tax the payment on the hybrid loan. As a result, Country B will allow B Co the tax deduction for the interest payment.

Example 2: OECD Hybrid Report Example 4.1 (page 299) – Use of a reverse hybrid



If A Co under Country A tax law treats the interest payments as derived in Country B (i.e. under Country A tax law, B Co is a separate entity) and B Co under Country B tax law treats the interest payments derived in Country A (i.e. under Country B tax law, B Co is transparent), there will be no recognition of income in either jurisdiction. In this situation, Country B would apply the reverse hybrid rule to deny Borrower Co's interest deduction.

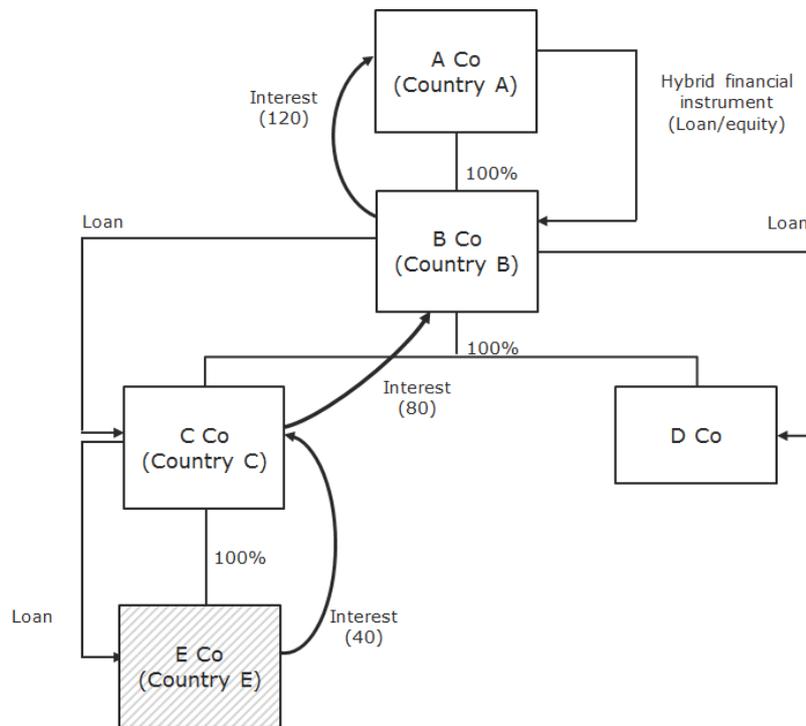
Example 3: OECD Hybrid Report Example 1.27 (page 246) – Interest component of purchase price



Because B Co claimed an interest deduction which was not matched by a corresponding ordinary income receipt for A Co, Country B would apply the hybrid financial instrument rule to deny B Co's interest deduction. If Country B has not implemented the hybrid financial instrument rule, or does not counteract the mismatch, Country A would apply the defensive rule and include that interest payment in the ordinary income of A Co. This result applies even if A Co has included the full purchase price (including the amount that from Country B's perspective is the interest component) in its amount realised and on which capital gains tax is paid under the laws of Country A.

As suggested by NZ's Discussion Document (at paragraph 5.29), if A Co was a trader and included the entire payment in their ordinary income, the hybrid financial instrument rule could still be applied by Country B to deny B Co's deduction. This is because "the application of the rules depends on the tax treatment of a payment of "ordinary status,""³⁴ i.e. B Co could be treated as if it was dealing with entities as holding the shares on capital account. In that situation, there is no actual D/NI outcome, but because one could have theoretically existed, B Co will still be denied an interest deduction.

Example 4: OECD Hybrid Report Example 8.1 (page 341) — Structured imported mismatch rule



In this situation, A Co and B Co are parties to a hybrid financial instrument. By way of on-lending arrangements between B Co and C Co, and then C Co to E Co, OECD's Hybrid Report suggests that the hybrid mismatch occurring between A Co and B Co is 'imported' into Country E, i.e. irrespective of whether E Co's interest deduction is matched by interest income by C Co in Country C, E Co's interest deduction in Country E is viewed as offset at the group level by the hybrid mismatch between A Co and B Co under the laws of Country A and Country B. In this situation, Country E would apply the imported mismatch rule to deny E Co's interest deduction even though the hybrid mismatch between A Co and B Co does not affect Country E's tax base. (Note: This rule appears to be premised on an ability to trace funds through different jurisdictions. If as is almost inevitably the case, the group operates via a centralised treasury function under which moneys are fungible it appears that the imported mismatch rule does not apply. With a hole this large, the question arises as to whether the rule should be introduced at all.)