#008

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 OECDs 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.

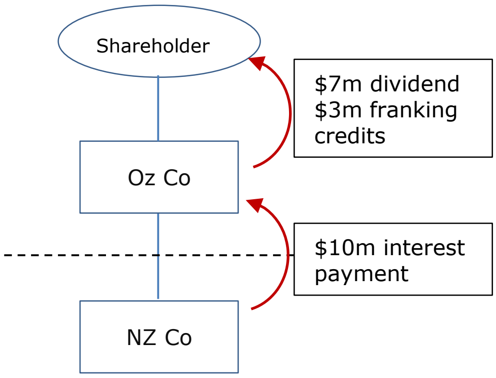
The Trans-Tasman context

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.

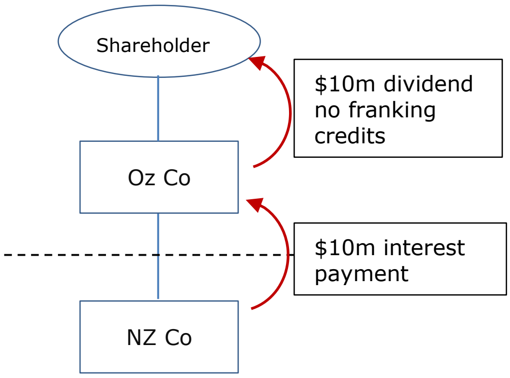
3.23 As an example, consider a New Zealand subsidiary of an Australian company with Australian resident shareholders. The Australian parent provides funding to its New Zealand subsidiary. Assume the New Zealand entity incurs an interest cost of $10m, which in scenario 1 below is incurred on an intercompany 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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