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) 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).