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Addressing hybrid mismatch arrangements
C/- Deputy Commissioner
Policy and Strategy
Inland Revenue Department
PO Box 2198
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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 grandparented 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 grandparenting 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 grandparenting 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
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