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Addressing hybrid mismatch arrangements
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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

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[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.

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[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
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