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Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
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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 grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting 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

Aaron Quintal
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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 Strategy[2] 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

[3] As 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 grandparented from the hybrid proposals. Alternatively, a lengthy grandparenting 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.

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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).

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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 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 instruments[13] 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 Report[15], 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

[15]See 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

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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 were 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 counties (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) Bill[18] 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, "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.