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NEW ZEALAND NEEDS A TAILORED APPROACH TO THE OECD'S PROPOSALS TO NEUTRALISE SO-CALLED "HYBRID MISMATCH ARRANGEMENTS"

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SUMMARY

1 This paper advocates for New Zealand to take a "tailored" approach to the "OECD Hybrid Report" [1] proposals. Under this tailored approach:

- NZ should reject any presumption that, without the need for further thought, the UK "General Principle Overlay Approach" should be adopted;

- NZ should make deliberate policy decisions in NZ's interest as regards each of the OECD policy recommendations and the extent to which each is adopted by NZ. To the extent the OECD proposals are to be adopted, specific new rules should be integrated into the existing statute (not served up as a stand-alone overriding subpart of the statute);

- some of the OECD Hybrid Report proposals should not be adopted at this time. At this stage our view is that rules that deny to foreign direct investors NZ interest deductions which would otherwise be allowed within NZ's existing framework should not be adopted. Such rules include the imported mismatch rule, the rule as regards disregarded payments by hybrid entities and the rule as regards payments made to a reverse hybrid.

2 The compelling reason for the suggested tailored approach is that adoption of the UK General Principle Overlay Approach, without further thought, would potentially have a significant adverse impact on the NZ Government's current policy emphasis on attracting more foreign direct investment into NZ.

3 There are a range of other reasons supporting the tailored approach: that hybrid mismatch issues are not a significant threat to the NZ tax base; that the full OECD Hybrid Report proposals are mind-boggling in their complexity (and NZ is not a "rhinoceros", see below); and that there are significant flaws in the foundations of the OECD Hybrid Report proposals. But in our view the Government's own policy as regards attracting FDI compels the tailored approach.

THE OECD PROPOSALS

4 The OECD Hybrid Report contains strong recommendations for major international tax changes requested to be delivered broadly by concerted domestic law tax changes by member countries.

5 The concern broadly addressed by the OECD Hybrid Report is double non-taxation, i.e. non-taxation (or low taxation) in both the source country of income and the country of residence of the investor. The report broadly targets hybrid mismatch arrangements that exploit a difference in tax treatment of an instrument or an entity

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1 OECD *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, (2015) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

under the laws of two or more countries which lowers the total tax costs to the parties to the arrangement.[2]

6 More specifically, the OECD Hybrid Report contains 8 recommendations for changes to the domestic law of member countries and a smaller group of recommendations for changes to the tax treaties. This paper focusses on the recommended domestic law changes. The outcomes sought to be counteracted by the OECD are broadly:

- **Deduction no inclusion outcomes ("*D/NI*"):** Payments giving tax deductions under the rules of the payer country and are not included in the ordinary income of the payee. The OECD proposed rules broadly target D/NI outcomes as a result of:

  (a) "hybrid instruments"; and

  (b) "hybrid entities".

- **Double deduction outcomes ("*DD*"):** Payments that give rise to deductions in two or more countries for the same payment resulting from hybrid entities or dual residents;

- **Indirect deduction/no inclusion ("*Indirect D/NI*"):** Payments that are deductible under the rules of the payer country and are set-off by the payee against a deduction under a hybrid mismatch arrangement. This is covered in rules directed at "imported mismatch arrangements".

Recommended rules to address D/NI outcomes

7 More specifically, but still at the helicopter level, we outline below the targets of the OECD's recommendations as regards D/NI outcomes. Yes, unfortunately even for a reasonably high level paper addressing NZ's policy response at a high level, we need to start by having some understanding of the detailed subject matter. Without that, no sensible conclusions can be drawn as to the best overall approach.

Hybrid Instruments

8 These are circumstances where a D/NI outcome is the result of:

- the terms of the financial instrument (broadly the payer country allows a tax deduction and the payee does not include income, for example because one country treats the payment as deductible interest and the other treats the payment as a tax-exempt dividend). See Examples 1 and 3 in the Appendix; or

- a hybrid transfer, by which is meant broadly a transfer of a financial instrument on terms where a mismatch arises because, following the transfer, one country treats the transferee as the owner of the financial instrument and another country treats the transferor as the owner of the same financial instrument. Sale and repurchase ("*repo*") agreements are an example; or

- substitution payments, by which are meant broadly payments under a transfer of a financial instrument which involves the making of payments

2 OECD *Neutralising the Effects of Hybrid Mismatch Arrangements*, (2014) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, at paragraph 41.

between the counterparties in substitution for the underlying return on the financial instrument. Securities lending arrangements are an example.

9 Hybrid instruments are covered in Recommendation 1 of the OECD Hybrids Report. The suggested primary response is for the payer country to deny the deduction for the payment to the extent that it gives rise to a D/NI outcome. A secondary "defensive" rule is also recommended: if the payer country does not act to deny the deduction, the payee country should in its domestic law require the payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

10 There then follow clarifications/exceptions, including that:

- the rule only applies to payments between "related persons" (generally 25% direct or indirect common ownership between the payer and payee) or pursuant to a "structured arrangement";

- the rule does not apply to mismatches solely attributable to the status of the taxpayer or the circumstances in which the instrument is held;

- the rule does not apply to timing differences provided that the income arises within a "reasonable period of time";

- the rule does not apply to certain investment vehicles;

- "payments" do not include "payments that are only deemed to be made for tax purposes and that do not involve the creation of rights between parties" (consequently, OECD's recommendations do not target accounting entries such as debt forgiveness or foreign exchange fluctuations for example, as debt forgiveness is not a "payment" made and foreign exchange differences are said only to reflect the nominal values assigned by jurisdictions to a payment rather than constituting payments in and of themselves[3]).

11 This rule is reinforced by Recommendation 2 which specifically requires that a payee country should not grant a dividend exemption for dividend payments that are treated as deductible by the payer. NZ law already provides for this outcome – see sections CW 9(2)(b) and (c) of the Income Tax Act 2007. Recommendation 2 also extends to restrict dual claiming of foreign tax credits for withholding tax at source under "hybrid transfers" (see above) where two countries see different persons as the tax owner of a transferred financial instrument.

Hybrid Entities

12 The disregarded hybrid entities rule in Recommendation 3 will most commonly apply where the payer entity is treated as opaque (a separate entity) by the payer country and transparent by the payee country. This rule targets a D/NI outcome that arises from a disregarded payment, which is a payment: deductible under the laws of the payer country; and that is not recognised under the laws of the payee country by reason of the tax treatment of the payer under the payee country's laws (i.e., generally, where the payee country treats the payer as transparent).

13 The suggested response is for the payer country to deny the deduction for the payment to the extent that it gives rise to a D/NI outcome. A secondary "defensive"

3 See analysis in OECD Hybrid Report at examples 1.17 and 1.20.

rule is also recommended: if the payer country does not act to deny the deduction, the payee country should in its domestic law require the payment to be included in ordinary income of the payee to the extent the payment gives rise to a D/NI outcome.

14 Again and similar to Recommendation 2, there are clarifications and exceptions, including that:

- the rule does not apply to the extent the deduction to the payer in the payer country is set-off against income that is included in income under the laws of both the payee and the payer countries (i.e., "dual inclusion income"), with any deduction in excess of the dual inclusion income being quarantined and offset against dual inclusion income in a future period;

- the rule applies only to parties in the same "control group" (generally 50% or greater direct or indirect common ownership) or for parties to a "structured arrangement";

- the rule can apply to current expenditure such as interest, service payments, rents and royalties. But it does not apply to the cost of acquiring a capital asset or depreciation allowances.

15 Recommendation 4 addresses D/NI outcomes from payments to "reverse hybrids". A "reverse hybrid" is any person that is treated as a separate entity by an 'investor country' (i.e., the country of residence of investor) and transparent in the 'establishment country' (i.e., where the entity is established). Reverse hybrids will most commonly involve payments from a 'third country' (i.e., where the payer is located) to the payee (the reverse hybrid and in which the investor invests) that is transparent in the payee country, but treated as a separate entity by the investor under the investor country's tax law. See Example 2 in the Appendix.

16 The suggested response in Recommendation 4 is for the payer country (i.e., the country from which the payer makes the payment <u>to</u> the reverse hybrid) to deny the deduction to the extent the payment gives rise to a D/NI outcome.

17 The clarifications/exceptions to the Recommendation 4 rule are that:

- the rule only applies where the investor/the reverse hybrid and the payer are members of the same control group (generally 50% or more common control) or if the payment is under a "structured arrangement" to which the payer is a party; and

- the rule only applies if the D/NI outcome would not have arisen if the payment was made direct by the payer to the investor.

18 Recommendation 5 recommends further countering reverse hybrids by: investor countries tightening their CFC rules to prevent D/NI outcomes for payments of reverse hybrids; and if the investor country does not act, the establishment country of the reverse hybrid bringing the reverse hybrid income into its tax net.

19 Recommendation 8 introduces the 'imported mismatch rule' to address D/NI outcomes which occur in multiple jurisdictions other than the payer country, but due to a lack of anti-hybrid rules are not addressed by those countries, and accordingly, are effectively 'imported' into the payer country. The suggested response in

Recommendation 8 is for the payer country to deny a deduction to the extent the payment from the payer country produces an indirect D/NI outcome under the rules of the payee country and another country. See Example 4 in the Appendix.

20 The clarifications/exceptions to this rule are that the payer, the payee and the other party must be within the same control group or the payment by the payee is under a "structured arrangement" to which the payer is a party.

21 This rule is hideously complex/ highly controversial and is addressed further below in the context of its potential negative impact on NZ's attraction of FDI. As noted in the OECD Hybrid Report, the imported mismatch rule would not be necessary with universal adoption of the other anti-hybrid recommendations, as the mismatch occurring between a payee country and another country would already be counteracted. See example 4 in the Appendix.

Recommended rules to address DD outcomes

22 Recommendation 6 addresses DD outcomes (deductions in two or more countries for the same payment) that are the result of an entity being a "hybrid payer". A hybrid payer broadly arises when:

- a company has a branch and a deduction is allowed for a payment both in the country where the branch is established and in the country where the company is formed; and

- an entity resident in a payer country is allowed a deduction for a payment in the payer country but a deduction is also allowed to the investor (or a related person) in the entity because the entity is treated as transparent under the law of the investor country.

  (The rule is stated more broadly, but these are the two primary examples.)

23 The suggested response is that the establishment country of the company with the branch/the investor country should deny the duplicate deduction to the extent it gives rise to a DD outcome. If that country does not act, a defensive rule is suggested under which the branch country/payer country should deny the deductions.

24 Clarifications/exceptions include that: the defensive rule only applies if the parties are in the same control group or the DD outcome arises under a "structured arrangement" and the branch/the payer are parties; the rule does not apply to the extent the deduction is set-off against dual inclusion income (to the extent exceeding current dual inclusion income, the deduction may be quarantined and offset against future dual inclusion income); the rule can apply to current expenditure, but does not apply to the cost of acquiring a capital asset or depreciation allowances.

25 Recommendation 7 counters DD outcomes for payments by a taxpayer that is a dual resident (i.e., where a taxpayer is a tax resident of 2 countries). Both countries are to deny the deduction for the payment to the extent it gives rise to a DD outcome. The rule does not apply to the extent that the deduction for the payment is setoff against dual inclusion income (excess deductions over the amount of dual inclusion income in a current year can be carried forward to set off against dual inclusion income in a future period).

INLAND REVENUE'S 2016 POLICY DISCUSSION DOCUMENT

26 The IRD Discussion Document[4] largely begins with the premise that the OECD rationale for the hybrid mismatch rules is appropriate.[5] The IRD suggestion is that:

- NZ should largely, without further thought as to the wisdom of the policy from NZ's perspective, adopt the full set of propositions put forward in the OECD Hybrid Report; and
- NZ's adoption should be comprehensive, rather than specifically targeted at known mismatch arrangements affecting NZ.

27 For reasons outlined below, this paper suggests that NZ should reject IRD's proposed approach and should in contrast consider carefully the approach to be taken and:

- be far more restricted in the degree to which the OECD Hybrid Report's proposals are adopted; and
- for those proposals that NZ does adopt, the law change should be integrated within the NZ current law, and not be a standalone subpart of the statute purporting to override the remainder of the statute.

28 Some small attempt is made in the IRD Discussion Document to suggest the possibility of NZ revenue loss from hybrid mismatch arrangements.[6] A suggestion is made that the *Alesco*[7] arrangements cost NZ approximately NZ$300 million in tax and that hybrid entity structures (presumably the reference includes Australian Limited Partnerships structures) result in approximately NZ$80 million NZ tax lost per year. We will address this in more detail below, but the *Alesco* arrangements almost certainly would have cost NZ no income tax. The NZ$80 million assessment of NZ tax loss on offshore hybrid entity structures (such as Australian limited partnerships) may indeed be accurate. What that suggests though is a small targeted adjustment to NZ's tax laws—it does not in any sense justify adoption of the full array of changes suggested by the OECD.

29 The IRD Discussion Document at paragraph 3.21 purports to show an example of pure economic loss for NZ from a hybrid financial instrument. But the loss identified in that example has already been counteracted and does not arise under the current law by virtue of section CW 9.

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4 Policy and Strategy at NZ Inland Revenue *Addressing Hybrid Mismatch Arrangements, a Government Discussion Document* (September 2015). ("*IRD Discussion Document*")

5 IRD Discussion Document, paragraphs 3.1 to 3.27. Of the 83 page document, 6 pages are devoted to the policy framework issues.

6 IRD Discussion Document, paragraphs 3.17 to 3.21.

7 *Alesco New Zealand Limited v Commissioner of Inland Revenue* (2013) 26 NZTC 21,003.

TWO POSSIBLE APPROACHES TO ANTI-HYBRID MISMATCH RULES: UK "GENERAL PRINCIPLE OVERLAY" OR A "TAILORED" APPROACH

UK "General Principle Overlay Approach"

30 What we describe as the UK "General Principle Overlay Approach" involves the UK's enactment of a separate standalone part (Part 6A) in TIOPA 2010[8] which largely seems to operate to override the tax consequences that would otherwise arise under the UK tax statutes in the absence of the new Part 6A. Part 6A extends to 68 pages of legislation and is expressed in broad terms along the lines of the principles in the OECD Hybrid Report. In Australia the ATO also seems to support a set of self-contained provisions along the lines of the OECD Hybrid Report. There is an ease to this approach from a perspective of IRD officials:

- little further thought need be given to the rational for the OECD's recommended changes;
- if anything, the legislation enacted will overshoot rather than undershoot the objectives and may result in double tax;
- problems and difficulties in interpreting the law are left for taxpayers to grapple with, and subsequent legislative corrections can be made where essential; and
- NZ can with ease tick the box as regards the OECD's recommendations and automatically be a fully compliant member of the country club.

Tailored Approach

31 The other approach, which we recommend, is for NZ to tailor its response and, to the extent the OECD's recommendations are adopted by NZ, NZ should deliberately integrate its response into the existing laws. Under this approach:

- NZ is required to make deliberate policy decisions as regards each of the OECD's policy recommendations. For each proposal the Government/Parliament will need to resolve the extent to which it should be enacted by NZ and how best to enact it and fit it into the current legislation; and
- the changes that are made are more likely from the outset to work as intended and be integrated into the NZ Income Tax Act in a way that is capable of understanding by a majority of taxpayers and their advisers.

NZ an early adopter or late adopter?

32 The tailored approach that we suggest is necessarily a tactical response by NZ to the OECD's recommendations that sees NZ able to show that it has "in essence" adopted to a considerable degree the changes suggested by the OECD, while at the same time ensuring that NZ's best interests are served and that NZ's tax system retains its integrity and simplicity as far as is possible. As a tactical response (rather than a tick the box adoption), we suggest NZ be a late adopter, rather than an early

[8] Taxation (International and Other Provisions) Act 2010 (UK).

adopter of these changes. Having regard to the approaches taken in countries that are NZ's major investment and trading partners will help NZ measure its response.

WHY NZ NEEDS TO TAKE THE "TAILORED" APPROACH

Context: Hybrid Mismatch issues are not a significant threat to the NZ tax base; a tailored response is sufficient

33 For proposed tax reform of this scale, it is elementary that the proposed tax reform is able to be justified by an identified threat or identified upside for the NZ tax base. Somewhat alarming is that the IRD Discussion Document does not even seek to identify a NZ tax base issue that justifies implementing proposed hybrid mismatch reforms on the scale suggested (see above).

34 Moreover, experience over the last 20 years makes it clear that there is in fact no NZ tax base upside/NZ tax base concern that justifies the proposed hybrid mismatch reforms. Over the last 20 years the only items we have seen that raise NZ tax base issues of the type addressed by the proposed hybrid mismatch reforms are set out below. Further, as we outline below, those issues are capable of being remedied or have been remedied, by tailored legislation/IRD determinations. So in our view it is clear that NZ tax base protection does not warrant an intrusion of anywhere near the scale suggested by the proposed hybrid mismatch reforms:

- ***NZ's Conduit Regime***: This was a significant NZ tax base issue resulting from a flawed legislative enactment:

    (a) The intention of the conduit regime was to relieve tax on CFC income and offshore dividends for NZ holding companies with offshore operating subsidiaries to the extent of non-resident ownership of the NZ holding company. The aim was to reduce the number of NZ holding companies moving offshore as they expanded by raising capital from non-NZ residents, as a result of NZ's overly aggressive CFC regime at that time relative to those of all other countries in the world;

    (b) One effect of the regime in the way it was enacted was that NZ's banks (mainly Australian owned) were literally allowed to reduce their tax liabilities by borrowing and investing in offshore preference shares issued by offshore financial institutions. This was also allowed to occur in circumstances where tax deductions were available to the offshore financial institutions in the UK/US in relation to the tax-exempt returns they paid to the NZ banks. IRD originally asserted that the reduction in NZ bank tax was intended as a policy matter. Some favourable IRD binding rulings were also issued. Billions of dollars of transactions were undertaken and a number of years later the IRD decided to challenge the transactions under the anti-avoidance regime and IRD succeeded in two High Court judgments (*Westpac*[9] and *BNZ*[10]). The cases were settled before appeals were heard. NZ changed tack, softened the CFC regime with an active business exemption, and the conduit regime was repealed. The issue was removed by tailored legislation;

[9] *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834.

[10] *BNZ Investments Limited & Ors v Commissioner of Inland Revenue* (2009) 24, NZTC 23,582.

- ***OCNs***: In recent years a number of NZ subsidiaries have raised capital by issuing optional convertible notes (option for the holder to convert the note into the subsidiary's equity) ("*OCNs*") to offshore parent companies (or associates). Under NZ's financial arrangement rules the OCNs could be on terms that they were interest free and the IRD's promulgated determinations under the financial arrangements rules allowed for notional interest deductions for the NZ subsidiaries. This occurred without any NZ withholding tax, as the financial arrangements rules did not apply to most non-residents. IRD recently succeeded in an anti-avoidance challenge for the notional interest deductions in *Alesco*, even though it is unlikely that in reality this was a NZ tax base issue; if investment had not been by OCN, similar tax deductions in NZ would have been available by a straight debt investment by the foreign parent company. In addition, in certain foreign jurisdictions, Australia being one, the tax laws did not require inclusion of income. Again this was arguably a flawed regime from a NZ tax perspective and has been amended by tailored amendment to the IRD determinations (new Determination G22A creates no phantom interest deductions in wholly-owned group contexts or where OCNs are held pro rata to equity);

- ***MCNs***: Investments by offshore parent companies/shareholders have also been made by way of mandatory convertible notes ("*MCNs*") into NZ subsidiaries. Again, NZ IRD determinations have allowed interest deductions for interest payments on the MCNs even to offshore parent companies or shareholders holding the MCNs proportionate to their equity investment. A number of offshore regimes (including Australia) have treated the MCNs as equity and allowed exemptions for the interest as exempt dividend income. Again, it is unlikely that there has been in reality a NZ tax base issue with these instruments; given, if not by way of MCN, NZ would have allowed interest deductions to the NZ company for interest expense incurred on straight debt financing. IRD has raised a number of tax avoidance cases involving MCNs, at least one of which has been settled by the taxpayer paying significant amounts.[11] Tailored amendment to the IRD Determinations could address this issue if it was viewed as problematic from a tax base perspective (see current Determination G5C);

- ***Perpetual Debt***: Certain jurisdictions treat perpetual subordinated debt as equity. This allows also for a similar type of arbitrage where NZ allows interest deductions and the investor country may choose to allow tax exempt dividends or foreign tax credited dividend treatment. Other mismatches may rise around debt/equity treatment, i.e. two further examples involve debt issued in substitution/proportion to equity (section FA 2(5), now repealed) and profit-related debentures (section FA 2). These last two are situations where NZ confers/has conferred equity treatment and a foreign country may treat an instrument as debt. Again, these have generally not caused NZ tax base issues because of the operation of section CW 9 (if the foreign country allows a deduction, NZ does not allow the tax-exempt dividend treatment).

- ***Bank regulatory capital***: It has been reasonably common practice for Australian banks with NZ subsidiaries to raise regulatory capital in ways that achieve tax deductions for interest on legal form debt issued by NZ subsidiaries/NZ branches, but where Australia has treated the instruments as equity allowing Australian franking credits to be attached to dividend

11 See APN News & Media (market announcement found here: https://www.nzx.com/companies/APN/announcements/284588)

payments to Australian shareholders for Australian tax purposes. There is real doubt in any claim by IRD that these transactions are negative for the NZ tax base. On their face, the transactions allow interest deductions in NZ within the NZ thin capitalisation constraints for banks and the amount of interest deduction claimed in NZ is reduced because the interest paid is reduced by the benefit Australian investors get from the Australian franking credit. So these transactions are, prime facie, beneficial to the NZ tax base – IRD does appear to seek by contorted analysis to suggest a tax base loss from these transactions. Even if IRD should succeed in convincing Government/Parliament that there is a tax base loss from these transactions, action can again be by way of tailored legislation rather than the proposed hybrid mismatch reforms (we note that even in the UK/Australia, which are pursuing the proposed hybrid mismatch reforms, they are carefully considering the degree to which the reforms should apply to bank regulatory capital);

- ***Australian limited partnerships and dual use of interest deductions***: The use of Australian limited partnerships by NZ parent companies to make investments into Australia in ways which give rise to interest deductions on debt finance being available in both Australia and NZ does appear to be a genuine NZ tax base issue. There are existing rules that protect against some importing of tax losses from offshore (see for example, CFC loss quarantining rules and section IC 7 rules preventing loss offset by a company treated as tax resident of another country). If there is a desire to protect against this issue, tailored legislation can be enacted. Again, this does not justify the full scale of the proposed hybrid mismatch rules.

35 As we have suggested, none of the above examples demonstrate a NZ tax base issue that justifies from NZ's prospective introduction of the UK General Principle Overlay Approach to the proposed hybrid mismatch rules. The only example we have identified as a genuine NZ tax base issue is the Australian limited partnership. Our view is that this, and any other issue considered problematic, can be addressed by a tailored solution.

36 We are also aware of a variety of mechanisms for non-NZ tax reduction in the context of acquisitions of NZ businesses. These include use of unlimited liability companies/branches as a mechanism for flow through to foreign tax jurisdictions (in particular the US) of interest deductions from acquisition debt raised in NZ to finance NZ acquisitions. But these do not raise NZ tax base issues. Rather, in these types of cases, the introduction by NZ of the proposed hybrid mismatch rules can only be justified as a mechanism for foreign tax base protection which we address further below.

Context: The "a plague on all your houses" rationale is not appropriate and does not justify the General Principles Overlay Approach in NZ

37 Discussions with IRD officials suggest that from an international perspective there is a measure of "utu" (revenge/payback) for international corporate behaviour that underlies the rationale for the OECD BEPS Project generally and, in addition, the proposals in the OECD Hybrid Report. Tired of continually being a step behind the intricate schemes of multinationals and their tax advisors, the proposals in the OECD Hybrid Report are intended to be designed so that, irrespective of how a taxpayer tries to get to the end result of tax reduction by a D/NI mismatch, their efforts are defeated by the new rules.

38 With that emotional style of rationale in support, the suggestion from officials is/might be: "don't talk to us about the impossible complexities of these rules and the increased compliance costs, you (the multinational corporates) have brought those on yourselves."

39 Even accepting the likelihood that there is a measure of truth in this in the European/US contexts, in our view the NZ experience does not in fact justify this response. That this is the case is evident from the real difficulty in identifying any significant systematic NZ tax loss from the types of transactions targeted by the OECD Hybrid Report.

Context: The "no go" zones rationale is not an appropriate rationale in NZ

40 The idea that the rules are deliberately complex/ virtually incomprehensible at the level of specific implementation and are designed to just create "no go" areas is in our view simply not a plausible proposition. This is because the rules cover potentially such a wide array of commercial activity that they simply cannot all be packaged up and placed in a "no go" area:

- Differing tax treatments between countries of branches/permanent establishments and limited partnerships bring the rules into play;
- Cross-border acquisitions with deferred purchase prices are potentially subject to this regime;
- Repurchase transactions/short sales and equity securities lending transactions are within the regime. In international markets there will be billions/trillions of dollars in the transactions, much of which will not be tax driven; and
- Bank regulatory capital raising may be within the regime.

41 It is not plausible to suggest that the rules in these areas should be deliberately complex/virtually incomprehensible at the level of implementing specific transactions so as to create "no go" areas in these zones. Indeed even in the UK/Australia context specific exceptions are being considered for bank regulatory capital raising and modest repo and short sale/securities lending transactions by traders i.e., the UK/Australia are prepared to tailor their response according to their economic interests.

Context: Limited to Intra Group Transactions and "structured arrangements" (i.e. tax avoiders)

42 We accept that, prima facie, the OECD Hybrid Report rules appear to be directed at broadly the correct target—being controlled groups of companies (who do have control of the full set of transactions that they enter into) and "structured arrangements" generally to which a taxpayer is a party. For this purpose, a taxpayer will not be party to a "structured arrangement" if it could not have been reasonably expected to be aware of the hybrid mismatch *and* did not share in the value of the tax benefit resulting from the hybrid mismatch. However, while aimed at the correct target, we can foresee significant issues for companies on audit (even if no evil being evident).

43 First, as regards the hybrid financial instrument rule, the OECD Hybrid Report suggests that parties do not need to be in a "control group," they simply need be

"related parties:" this is a lower 25% threshold for association particularly when aggregation rules are considered.

44 Secondly, the objective test for "structured arrangements" means that there is a real risk of overreach. Given the rigorous nature in which tax authorities conduct audits, taxpayers may face considerable costs when faced with an allegation by tax authorities that the taxpayer knew or "could reasonably have been expected to be aware" that a hybrid mismatch existed. Further, demonstrating that a taxpayer did not share in any of the tax benefits arising from the hybrid mismatch may be an expensive/complicated process requiring specialist investment banking advice. This test creates an opening for tax authorities to deploy considerable pressure and extract payments by way of settlement in order to bring a tax dispute process to an end.

Context: NZ should not adopt the mind-boggling complexity/uncertainty created by General Principle Overlay Approach

45 Our attempt at a simple outline of the recommendations in the OECD Hybrid Report cannot fully disguise the scale of the complexity that is involved. The Report is more than 450 pages of text, with 300 of those pages dedicated to 80 examples. To give some sense of this, working with one of NZ's top tax policy officials, our Chapman Tripp tax team had the pleasure of spending around 2 hours debating just one of the examples. At the end of that time there was no consensus as to whether the result in the example was correct; and this is before there is any legislation (to those who are tax practitioners, the language of the legislation often obscures, rather than clarifies, the principles). We discovered that even assessing whether a D/NI result occurs is intricate, given that NI arises when an item is not included in "ordinary income" as defined (a definition which excludes income benefitting from an exemption; exclusion; credit or other relief).[12]

46 The complexity includes:

- The revolution of having NZ's tax treatment of a broad array of transactions turn on the tax treatment of the transaction in one or more other countries under their foreign law. The NZ tax treatment may turn on tax treatment in multiple counties, not just the treatment in one other country; consider for example Recommendations 4 (reverse hybrids) and 8 (imported mismatches). (Many object to this approach on the grounds that it undermines a country's national sovereignty as regards the imposition of taxes.)

- Where there is uncertainty in the foreign tax laws as to the outcome (whose tax law is after all certain in its scope?), that foreign tax law uncertainty is, under the OECD Hybrid Report approach, imported into the NZ law results. As a practical matter in the context of tax audits being run by two or more countries, current tax disputes practices do not allow for the tax administration in one country to resolve its tax position having regard to the outcomes of a determination of the tax position in another country. For example, if interlinked tax systems of the type envisaged in the OECD Hybrid Report are to be adopted worldwide, it would seem essential for there to be special mechanisms to allow for integration of tax disputes in relation to the application of those rules under the domestic tax laws in each country. The tax treaty dispute resolution mechanisms (themselves not very effective) do

12 See OECD Hybrid Report, paragraph 42.

not even apply in the context of interlinked domestic tax law disputes under the OECD Hybrid Report proposals. No such mechanism has yet been suggested. What might be necessary are delays in domestic tax dispute timing rules and an expanded ability to reopen tax returns (to allow the domestic effect of subsequent foreign law determinations to be taken into account).

- Although the OECD Hybrid Report suggests a series of principles, it leaves each country to adopt rules for their own tax systems. Each country therefore selects its own form of enactment, in its own language, and with its own exceptions. Even if all countries embraced the OECD Hybrid report fully (which they do not), there would be no reality to the idea that all countries would be enacting the same thing.

- Ongoing changes in the tax laws of other countries would affect NZ tax results. So as regards multi-year transactions, the requirement to take account of foreign tax laws in determining NZ tax treatment is an ongoing one which needs to be updated as foreign tax laws change.

- Use of the "General Principle Overlay Approach" would add to the complexity in terms of determining the practical effect of the rules enacted. It seems obvious and elementary that if the NZ legislature enacts tax legislation it should have considered and understood its scope and effect, and affirmatively have chosen to enact the legislation understanding its consequences. It had not occurred to the authors of the OECD Hybrid Report, for example, that the reverse hybrid rule would apply to NZ's foreign trust regime. Now it is a good thing that IRD have focussed on this possibility; otherwise, simply enacting the OECD Hybrid Report on a general principle overlay basis, without any further thought, would have had the effect that NZ's foreign trust regime would have been effectively repealed without the legislature even knowing that this was what it was doing. This would have been the case even though the Shewan report on NZ's foreign trust regime (concluded only in July 2016) took the view that no NZ taxation of foreign source income of a foreign trust under the existing law was an appropriate policy setting.[13] We suggest the tailored approach to ensure that other inadvertent changes in tax settings do not occur without thought.

47 Clearly this interaction of NZ law with foreign laws will dramatically increase the compliance costs for taxpayers—not only will taxpayers now require specialist tax advice from foreign jurisdictions to determine how NZ's own laws will apply to their potential deductions, the advice requires knowledge of the tax outcomes and tax filing positions for counterparties who may, especially in the context of "structured arrangements" between unrelated parties, have no shared interests and no desire to disclose such information. Moreover, in "structured arrangements" the suggestion may well be that a counterparty needs to warrant its foreign tax treatment and, if this proves to be incorrect and causes NZ tax loss, the foreign counterparty should indemnify the NZ counterparty for the NZ tax loss. This would overthrow norms of international risk allocation. If a foreign counterparty is not prepared to take an NZ tax risk, the NZ counterparty is left bearing NZ tax risks that turns on foreign tax treatment but without assurance as to the accuracy of the foreign tax treatment on which the NZ tax position relies.

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13 John Shewan *Government Inquiry Into Foreign Trust Disclosure Rules* (New Zealand Government, June 2016), at paragraphs 4.18 and 13.25-13.28.

48 We do not necessarily expect mind-boggling complexity to stop the OECD Hybrid Report proposals in their tracks in NZ. We anticipate that more will be required by Inland Revenue before a tailored approach will be taken in NZ. But NZ is too small to ignore the costs of complexity. As Lee Sheppard observes in a 2015 Article:[14]

> "Why do Americans have such an appetite for complexity? Americans don't have to think about systemic administrative costs. ... The United States is a very large country, with a very large economy, so administrative costs that would kill a smaller country are a pinprick on a rhinoceros hide".

49 In this context, it is self-evident that NZ is not a rhinoceros (noting also that it appears that the US itself will not adopt the OECD Hybrid Report proposals).

Context: NZ needs to recognise the flawed foundations of the Anti-Hybrid Mismatch Proposals

Not all countries will be in

50 A basic tenant of the 'country club' rationale is that all nations, particularly those for whom the rules were primarily developed, must actually be implementing the rules themselves. Without this global commitment, there is no justifiable reason why NZ should bear the implementation costs, compliance costs and complexity of a regime that benefits other nations if other beneficiaries will not share in that same burden. Though the IRD Discussion Document shows the NZ Government's "expectation that [other] countries that are part of the consensus will act,"[15] a survey of other nations shows that this is not likely to prove entirely accurate:

- Early adoption is currently spearheaded by the UK, having already enacted anti-hybrids legislation that will be effective on 1 January 2017.[16] While the UK is adopting almost the full spectrum of complicated rules, this is arguably justifiable given the potential scale of hybrid abuse in the UK. Notwithstanding these problems, UK has targeted exemptions for regulatory capital,[17] stock loans and repos which will largely reduce the impact of these rules on its banks and financial traders, despite the likelihood that those groups are key beneficiaries of hybrid mismatch arrangements.

- Though without publishing any actual legislation, Australia has also made significant progress towards adopting anti-hybrid measures. From its public consultations, we expect that Australia will adopt versions of OECD's recommendations to be effective no earlier than 1 January 2018. Importantly however, Australia also proposes to modify OECD's recommendations where

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14 Lee A. Sheppard, "BEPs Action 2(Hybrid mismatches), The Hybrid Hydra" (October 2015), Tax Notes International.

15 At 1.11.

16 Schedule 10, Finance Act 2016 c.24 (UK).

17 Despite indications from the UK that its exclusion of regulatory capital is a temporary measure there is no certainty that regulatory capital will ever be included in a meaningful fashion, given that UK's earlier intentions to include it (see HM Treasury "Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements" (December 2014)) were successfully blocked by the industry.

necessary to advance its own interests.[18] Australia may also exclude regulatory capital.[19]

- The EU also intends to implement anti-hybrid legislation, having proposed two council directives that address hybrid mismatches in the context of broader tax reforms. EU measures differ depending on whether the mismatch occurs between two EU member states or an EU member state and a third party:

  (a) The directive to address hybrid mismatches between EU members is effectively a restatement of the primary rules contained in Recommendations 1, 3, 4 and 6, i.e. member states are instructed to deny deductions for payments made in the presence of a DD or D/NI outcome.[20]

  (b) In contrast, the directive to address external mismatches requires the implementation of both primary and secondary rules which includes the imported mismatch rule.[21]

- EU's proposals require EU member states to introduce domestic law by 31 December 2018 to give effect to the directive. Given the differences between each member's tax systems and intra-EU competition for inbound investment, one should not expect complete uniformity between the approaches of member states.

- China indicated an intention to introduce anti-hybrid rules in 2015, but we have not identified any publically available English guidance on what form these rules may take. However, fully-fledged implementation is unlikely as hybrid instruments in China are already curtailed to a large degree by its capital and foreign exchange controls.[22]

- Though US "check-the-box" rules are likely the largest facilitator of hybrid mismatch arrangements in the world, it seems likely that the US will only adopt token anti-hybrid measures, if any (President-elect Trump and Republican majorities in both the Senate and the House are not likely to lead to broader adoption of anti-hybrid measures by the US, but stranger things have happened!).[23] Consequently, Canada is also unlikely to adopt any meaningful anti-hybrid measures because it will not risk placing its multinational companies at a competitive disadvantage to those in the US.

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18 Limited reverse hybrid rules (no Recommendation 5); no limit for relief on foreign withholding tax (no Recommendation 2.2); potentially excluding the imported mismatch rule (Recommendation 8).

19 AT Board was due to report back on regulatory capital by the end of July 2016 but had not done so at the time of writing.

20 Article 9: Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the market (COM (2016) 26 Final).

21 Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (COM (2016) 687 Final).

22 KPMG "China – response to BEPS" (2 June 2016) KPMG <https://home.kpmg.com/xx/en/home/insights/2016/06/beps-action-plan-china.html; http://www.internationaltaxreview.com/Article/3511704/China-at-the-forefront-of-global-BEPS-implementation.html> (accessed October 2016).

23 Powerful members of the US legislature such as Senator Orrin Hatch (Utah) and Speaker Paul Ryan (Wisconsin) are publically opposed to any BEPS initiative that could potentially detriment US taxpayers and have stated that the US "shouldn't be negotiating agreements that undermine our own interests for the sake of some supposedly higher or nobler cause. The interests of the United States – our own economy, our own works, and our own job creators- should be our sole focus."

- At the time of writing, no concerted initiatives had been reported for Singapore or Japan.[24]

51 Although the rules have been designed to allow for the possibility of non-adoption by all countries, in the present context it would be naïve for NZ simply to adopt a UK General Principle Overlay Approach without more thought. In our view, a tailored approach is required.

Tax Havens are protected; imported mismatch rules problematic

52 As a general rule, the OECD Hybrid Report proposals do not attack tax advantages from, for example, paying tax deductible payments from companies in high-tax countries as income to companies established in tax havens or low-tax countries. Broadly, it is only tax reduction by virtue of the hybrid nature of the instrument or the hybrid nature of the entity that is targeted (although there is room under the regime for technical foot-faults that produce increased tax liabilities).

53 In this sense, tax havens/low-tax countries can be regarded as protected and encouraged by the OECD Hybrid Report. In our view, this state of affairs seriously undermines the integrity of what is being done. By not addressing the tax haven/low-tax question, the OECD Hybrid Report proposals may prove to be largely ineffective in taxing returns on multi-national capital flows. To some considerable extent it can be predicted now that in 10 years' time these rules may have proven to be largely ineffective in raising increased tax on returns on capital flows. How will governments and the public view the outcome if, for all this complexity/ compliance cost, there is no significant benefit in terms of taxation of returns on capital flows?

54 That result may well happen because nothing is done to attack investment in straightforward debt instruments from low tax/territorial tax jurisdictions (e.g. Ireland/Switzerland/Singapore/Hong Kong). So the corporate response can be expected to capitalise more and more treasury operations based in those jurisdictions. It can also be anticipated that over time an increasing number of countries will operate a territorial or low tax regime to attract this type of activity. In this paradigm, clearly high value jobs will increasingly locate in those jurisdictions who use their tax system to attract this type of activity:

> "Planners are responding to European countries' efforts by using plainer debt instruments under which payments are made to low-tax jurisdictions. The BEPS report is not an anti-conduit effort. It does not cover back-to-back loan schemes that do not involve hybrids. And it doesn't ask questions about the tax rate imposed on a deductible item as long as the payee has to recognise it under local law".[25]

This likely ineffectiveness is one factor to be taken into account in our conclusion that the tailored approach is appropriate.

55 In principle we object to the imported mismatch rule on the grounds that it has the potential to have a negative impact on NZ's attraction of FDI. We also make the point also that the imported mismatch arrangement rule seems to have a real problem in terms of the integrity of what is being done. The report suggests that

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24 Deloitte "BEPS Actions Implementation Matrices" Deloitte <https://www2.deloitte.com/global/en/pages/tax/articles/beps-action-implementation-matrices.html> (accessed October 2016).

25 Lee A. Sheppard, "BEPS and EU Progress Report" (June 2016) Tax notes International at 1217.

this rule should only apply where the funds can be traced from the hybrid mismatch to the country that is importing the mismatch. Consider Example 8.1 (page 341- 3 and in particular paragraph 8 of the Example; an extract of which is included as Example 4 in the Appendix to this article). An approach that depends on "tracing" of funds through multiple layers higher up in a multinational is most unlikely to be effective — it requires mass tracking of all intragroup transactions much higher up in a corporate chain to determine whether interest deductibility in NZ is allowed; while at the same time allowing anyone who wants to avoid the rule to avoid it by setting up a fungible treasury function at some point in the chain between NZ and the higher tier hybrid financial instrument that breaks the "tracing" chain required before the rule can operate. If there is to be an exclusion where there is an inability to trace, the rule will not be effective and in our view should not be adopted in the first place. The fact that an exclusion of this type is contemplated strongly suggests that the proposal had a significant degree of overreach from the outset.

Country Club to protect other countries' perceived aggregate interest vs NZ's interests

56 That the whole rationale for the hybrid mismatch payments rules is highly questionable can be seen from a simple example in two real life scenarios:

(a) Assume Australia is, in relation to regulatory capital instruments, to allow franking credits to Australian investors for franking credits attached to payments that are treated as tax deductible interest payments from NZ branches of Australian banks. If that is the case, what purpose is NZ achieving by enacting the hybrid financial instrument rule? If Australia affirmatively chooses not to counteract the tax benefit on these instruments, what is NZ acting to protect when it deploys the hybrid instruments rule to deny the interest deduction in NZ? Note in particular that availability of the franking credits actually reduces the interest paid to the Australian investor and therefore reduces the interest deduction against the NZ tax base that would be claimed if Australian franking credits were not allowed in Australia.

(b) To similar effect, what purpose is NZ achieving if NZ deploys the hybrid instruments rule to deny a deduction in NZ for a payment treated as interest expense by NZ in respect of a foreign investor located in a country that treats the payment as a dividend and which has deliberately chosen not to adopt the rule in Recommendation 2 (i.e. has chosen not to adopt a rule the equivalent of NZ's section CW 9(2)).

57 We find these questions particularly difficult to answer. Given that Australia/the foreign country has deliberately chosen not to act in conformity with the OECD Hybrid Report proposed rules, NZ's denial of interest deductions in the examples clearly would not be advancing Australia's/the foreign countries' perception of its own interests. In this case, it seems that NZ is supposed to act to deny tax deductions on what NZ sees as legitimate interest expense because of some broader bond to support the interests of a broader "country club" beyond the counterparty country. NZ offers to step into the breach to honour the interests of the "country club" even though the counterparty country has deliberately chosen not to support the "country club". Really??

58 Professor Graeme Cooper suggests a slightly different, but similar, issue with the OECD Hybrid Report rule:

"One remarkable, but unstated, implication arising from [the OECD Hybrid Report rules] … is the conclusion that these rules are attempting to ensure all income must be taxed at least once, but it does not matter where. Whether the tax is collected under the response rule or the defensive rule is immaterial. Indeed, the positions expressed in the six rules are not reached on the basis of any overarching principle. The Recommendations Paper deliberately avoids any attempt to determine which state has lost revenue and which state should benefit by a greater revenue collection. Consequently, which state ultimately collects revenue from implementing the recommended rule could be arbitrary or driven by strategic behaviour."[26]

59 He understandably views this as at odds with the BEPS mantra that profits should be taxed "where the economic activities that generate the profits are performed and where value is created." He also raises, and we agree with, the oddity of the constant use in OECD Hybrid Report proposals of denial of deductions as the solution to all hybrid problems, even if they are driven by something other than a deduction.

60 Where a country does not introduce the rules at all, or only implements certain rules, or chooses to leave holes in its rules, NZ needs to recognise that adopting every recommendation in the OECD Hybrid Report will result in the entire increased tax impact of the rules occurring in NZ (and not in the foreign counterparty country). NZ needs carefully to consider the economic consequence of that tax impact. In these circumstances, it simply cannot be that NZ blindly adopts the full rules without question.

Double tax is imposed

61 Oddly, although seeking to eliminate double non-taxation, the OECD Hybrid Report proposals result in imposition of double taxation in a number of situations. For instance, in Example 3 in the Appendix the interest deduction is denied to B Co even if A Co is paying tax on the sales process. Similarly, the proposals promote double taxation by ignoring withholding taxes in determining whether a hybrid mismatch arrangement produces a D/NI outcome, i.e. the OECD Hybrid Report rules might apply to treat a transaction as producing a NI result, even where source country withholding tax is imposed (withholding rates under domestic law can be as high as 30%). The OECD Hybrid Report explains the rationale for this as follows:

[at 407] "The function of withholding taxes under the laws of the payer jurisdiction is generally not to address mismatches in tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source."

62 The logistics of tax disputes in two different countries also create a significant risk of double taxation for corporate groups—resolution of uncertainty in one country may not come in a timely manner for another.

63 The logic of the framework is called into further question because, even where the OECD Hybrid Report rules actually operate to deny a deduction for interest expenses, the OECD still suggests that the payments be treated as interest for the purposes of imposing withholding tax (i.e. as if the deduction had not been denied). The NZ Government suggests that this approach be accepted at paragraph 11.4 of the IRD Discussion Document.

26 Graeme S. Cooper "Some thoughts on the OECD's recommendations in Hybrid Mismatches" (July 2015) Bulletin for International Taxation.

Context: NZ's policy to attract FDI requires the Tailored Approach

NZ Government policy seeks to attract additional FDI

64 Current NZ Government policy announced in July 2015 seeks to attract increased FDI under a new NZ Investment Attraction Strategy. An extract from the Cabinet Paper approving the strategy states the principles and sets a clear target as follows:

> "Achieving the government's goal of building a strong competitive economy with increasing numbers of higher paid jobs will require ongoing significant increases in business investment, and international investment will be an important source of capital to fund this increase. High quality international investment will assist with increasing exports to 40 percent of GDP, help lift research and development intensity to one per cent of GDP, and bring additional benefits to the economy. We have not yet been as effective as we can be in attracting the type of high quality international investment we need.
>
> ...
>
> *Theme 1: attract high-quality foreign direct investment in areas of competitiveness for New Zealand*
>
> *...*
>
> ***Target***
>
> We propose the target for theme 1 be to facilitate investments with a potential direct economic impact of $5 billion over three years."

65 Moreover, the FDI piece is part of a broader integrated framework that includes attracting overseas investment in R&D and attracting entrepreneurs to reside in NZ. This strategy was stated to be based on "an aligned, whole-of-government effort to attract high-value FDI".

66 This strategy is consistent with economic research that shows that FDI brings benefits to a country: it creates economic growth, increases jobs, lifts productivity and also provides access to new ideas and technology.[27] In contrast, a lack of FDI may result in increased interest rates, reduced consumer spending and eventually, reduced employment.

67 So any proposed adoption of the OECD Hybrid Report proposals must first address carefully the question of potential adverse impact on the existing NZ Government policy under which NZ seeks to attract more FDI.

68 The IRD Discussion Document does not address the consequence of adopting the OECD Hybrid Report proposals for NZ's FDI attraction strategy. The draft IRD tax framework for inbound investment (June 2016) at least begins the discussion:

> "An important priority for the future will be to consider measures to address BEPS. This includes consideration of rules to address hybrid mismatches and the possibility of tighter interest limitation provisions. When addressing these

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27 NZIER *Foreign Direct Investment in New Zealand: A brief review of the pros and cons* (NZIER, March 2016) at 3; MBIE *Business Growth Agenda: New Zealand Investment Attraction Strategy* (MBIE, 2015).

issues the focus will be on doing what is in New Zealand's best interest but, at times, this may mean co-operating with other countries to achieve a more efficient worldwide outcome and seeking to gain our share of a bigger worldwide pie."[28]

69 Indeed, the IRD paper confirms the need for careful testing of each of the BEPS initiatives, including the OECD Hybrids Report proposals:

> "Each [BEPS initiative] needs to be looked at critically from New Zealand's point of view."[29]

International tax competition and sensitivity of FDI to tax; adverse impact on NZ FDI attraction of OECD proposals

70 We do not address here the detail of the tax framework as regards FDI. Although increases in effective tax rates do not have a perfectly linear relationship with reductions in FDI, OECD studies nevertheless conclude that for every 1% increase in effective tax rates FDI will be reduced by 3.75% on average.[30] There is therefore legitimacy to the proposition that NZ seeks to attract FDI in a context of international competition as regards taxation on FDI. IRD's commentary acknowledges the relationship between tax levels and FDI generally:[31]

> "Taxes can have important effects on the incentives for non-residents to invest in, or lend money to, NZ… Excessive taxes on inbound investment can get in the way of this happening. It is also important that inbound investment takes place in the most efficient ways. Poorly designed taxes can hamper investment from occurring in the ways which provide the best returns to NZ."

71 The existence of economic rents (foreign investors who need to be in NZ to make their profits and are therefore less sensitive to NZ taxes) and foreign tax credits for offshore investors in their home jurisdictions mean that it is difficult to assess with precision the impact of NZ taxes on the ability of NZ to attract FDI. We believe that the type of marginal increase in FDI that the NZ Government seeks to attract under its new policy is likely to be more sensitive, rather than less sensitive, to the imposition of NZ tax. This FDI is not occurring naturally in NZ now so it seems to us less likely that this FDI falls into the economic rents category. If that assessment is accurate then NZ needs to take particular care as regards the potential for adverse effect on NZ FDI attraction from introduction of the OECD Hybrid Report proposals.

72 Current FDI into NZ arises as follows:[32]

Country	FDI in 2016	Total NZ FDI (% of total)	Position as regards OECD Hybrid Rules?
Australia	$537m	$50,659m (51.5%)	Yes

28 Policy and Strategy at NZ Inland Revenue *New Zealand's taxation framework for inbound investment: a draft overview of current tax policy settings*, (June 2016) at page 26; and see pages 20-22.

29 Ibid 28, at 22.

30 OECD *Tax Effects on Foreign Direct Investment* (2008) Policy Brief. See generally IRD June 2016 draft overview; OECD – Executive Summary of Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis (2007); NZ Tax Review 2001 Final Report, at page 20-21,75-83 and Annex E at 133.

31 Ibid 28, at 3.

32 NZ Trade & Enterprise Statistics <www.nzte.govt.nz/en/invest/statistics/> (accessed October 2016).

United States	$100m	$7,686m (7.81%)	Unlikely
Singapore	$418m	$5,651m (5.74%)	Unknown
Hong Kong	$109m	$5,503m (5.6%)	Unknown
United Kingdom	$-956m	$5,367m (5.45%)	Generally yes
Canada	$339m	$4,275 m(4.3%)	Unlikely
Netherlands	$718m	$4,235m (4.3%)	Likely yes (EU)
British Virgin Islands	$3,009m	$3,009m (3.06%) (Assumed from other countries—UK?)	Unlikely

73 Also of relevance are expectations as to the countries from which future FDI into NZ is expected to originate. Given expanding trade relationships with the Asian region, it seems quite plausible that FDI into NZ from the Asian region may over time increase in significance.

74 In assessing the significance of Australia's FDI into NZ (51.5% of the stock of FDI) and the extent of Australia's adoption of the OECD Hybrid Report proposals, it needs to be observed that the vast majority of Australia's FDI is in the financial and insurance sectors (76% in 2012)[33]. In this regard NZ needs to be close to the Australian position on application of the OECD Hybrid Report proposals as regards bank/ insurance company regulatory capital (this is still under review in Australia).

75 Important for any foreign investor is understanding NZ's effective tax rate on their investment. This is an average of the effective NZ tax rate on equity investment (28% corporate tax rate) and the effective NZ tax rate on any related party debt investment (generally 10% NRWT on related party interest and a 10% limit under the relevant NZ tax treaty, assuming deductibility in NZ of interest on the related party debt). NZ's thin capitalisation limit constrains total debt financing including both related party debt and non-related party debt (generally to 60% of total assets).

76 Critical then to FDI investors is for them to understand in particular the extent to which they are able to deduct interest on related party debt. It is here that NZ adopting the OECD Hybrid Report proposals becomes problematic from the non-NZ investor's perspective.

77 For example, assume for the moment that the USA/ Canada/ certain Asian countries do not adopt the OECD Hybrid Report proposals. If NZ does adopt the OECD Hybrid Report proposals in full, non-NZ investors from those countries face the possibility that NZ interest deductions in relation to related party debt may be denied (and their after tax returns reduced) in circumstances where:

- the related party lending to the NZ entity/ branch is by way of a hybrid financial instrument (e.g. MCN) that otherwise produces a D/NI outcome (this is the result of Recommendation 1 where the country of residence of the investor has not adopted Recommendation 2, for example the country of residence of the investor does not prevent a tax exemption for the payee where interest payable on the MCN is tax deductible to the payer);

33 Statistics New Zealand <http://www.stats.govt.nz/tools_and_services/newsletters/economic-news/may-13-direct-investment-with-australia.aspx.> (accessed October 2016).

- interest on the related party lending is paid to an offshore hybrid entity or reverse hybrid entity, in which case issues as to interest deductibility in NZ may arise under either Recommendation 3 or Recommendation 4; or

- the related party lending is linked under the imported mismatch rules to a hybrid mismatch higher in the corporate group.

78 How then will those investors evaluate NZ as an investment destination? One thing is sure—they will need to understand the nature of any risk they have that interest expense that they are expecting to be tax deductible in NZ may in fact prove to be non-deductible. This is potentially of direct and immediate importance to the investor's after tax returns. If all the world adopted the proposals on identical terms then the risks and compliance costs of the OECD proposals could be expected to be similar for all investment destinations and NZ's adoption should not in that case be problematic in terms of FDI attraction.

79 But our example presumes what is likely to be the reality: that USA/ Canada and significant parts of Asia do not adopt the rules at all or do not adopt the rules in full. If this is the case then investors from those countries will have options to invest in countries other than NZ where they are not subject to the risks of reduced after tax returns (by elimination of the benefit of arrangements that are available to produce lower tax imposts for returns on their investment or the risk of such an adverse outcome) and where they are not subject to the compliance burden of trying to ensure that the OECD rules in fact do not harm. We see real potential for adoption by NZ of the OECD rules to adversely affect the NZ Government's policy of attracting FDI from investors in those countries.

80 There seems to be more complexity in assessing the relative position of investors from countries that adopt the OECD Hybrid Report proposals when comparing investment in: NZ (if it adopts the OECD proposals); and investment in another country where the proposals have not been adopted. Critically this will also depend on whether the investor country has also adopted the secondary defensive rules. But what is clear is that the non-adopting country into which the investor may invest will be a far simpler proposition from the perspective of the investor determining their tax liabilities than New Zealand will be if it adopts the OECD Hybrid Report proposals in full. In particular, the investment into the non-adopting country by the non-NZ investor will not have interest deductions potentially denied under the hybrid financial instrument rules, the disregarded payment by a hybrid rule, the payment made to a reverse hybrid rule or the imported mismatch arrangement rule; and the investor into the non-adopting country will not have to deal with the compliance burden of the OECD rules in calculating its non-adopting country tax liability.

81 Whether a lower tax in-country burden for the investor in a non-adopting country transforms into higher after tax returns (including investor country tax) for the investor is another issue and is dependent on the way in which the investor structures its investments and the degree to which the investor country adopts the OECD recommendations. Some of the OECD rules have secondary responses that are relevant to the investor in the case of investment in non-adopting countries and they may trigger tax liability in the investor's country of residence (for example as regards hybrid financial instruments and disregarded payments made by a hybrid entity, the secondary responses in the OECD rules adopted by the investor country may trigger a tax liability for the investor in its country of residence). But for some of the other rules there is no secondary response (for example there is no secondary rule for imported mismatch arrangements and none for payments made to a reverse

hybrid—see generally the chart at page 20 of the OECD Hybrid Report for a useful chart providing an overview of the proposals). So in these types of cases where there is no secondary rule (and if the investor country has not adopted other suggested OECD amendments to buttress its offshore tax regime):

- an investor group investing in the future into an NZ that adopts the full OECD Hybrid Report proposals may have significantly higher tax costs in NZ than they would do if they invested in the non-adopting country; and

- those lower tax costs for the investor group in the non-adopting country may well produce higher after tax returns to the investor group, even after taking account of investor taxes. This because, even though the investor's country of residence has adopted the OECD Hybrid proposals, those proposals do not, as regards the three rules identified, have secondary responses that affect the investor's tax liability in its country of residence.

Preliminary thoughts on the tailored approach NZ should take

82 This paper advocates for New Zealand to take a "tailored" approach to the OECD Hybrid Report proposals. Under this tailored approach:

- NZ should reject any presumption that, without the need for further thought, the UK General Principle Overlay Approach should be adopted;

- NZ should make deliberate policy decisions in NZ's interest as regards each of the OECD policy recommendations and the extent to which each is adopted by NZ. To the extent the OECD proposals are to be adopted, specific new rules should be integrated into the existing statute (not served up as a stand-alone overriding subpart of the statute);

- some of the OECD Hybrid Report proposals should not be adopted at this time. At this stage our view is that rules that deny to foreign direct investors NZ interest deductions which would otherwise be allowed within NZ's existing framework should not be adopted and this would include the imported mismatch rule/ the rule as regards disregarded payments by hybrid entities and the rule as regards payments made to a reverse hybrid.

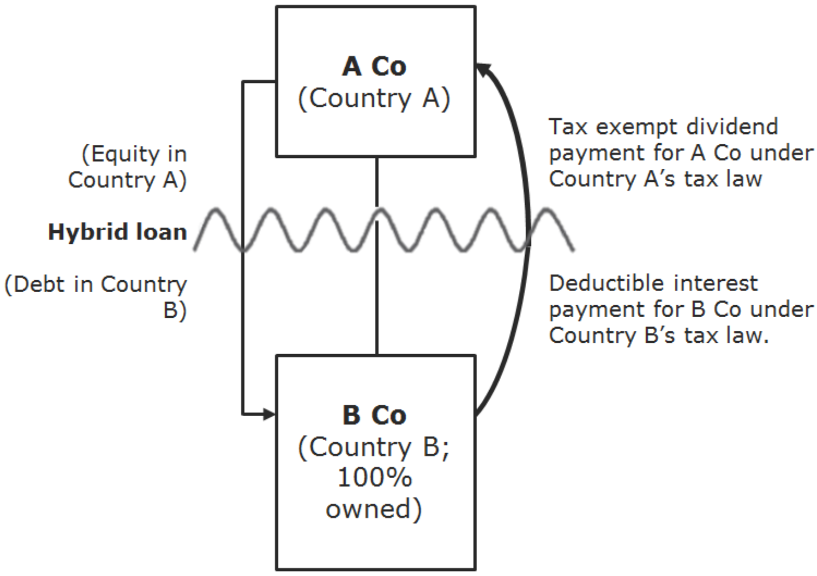
83 The compelling reason for the suggested "tailored" approach is that adoption of the UK General Principle Overlay Approach, without further thought, would potentially have a significant adverse impact on the NZ Government's current policy emphasis on attracting more foreign direct investment into NZ. We believe that this issue has not yet been fully analysed and that the analysis needs to be undertaken and fully tested before adoption of the OECD Hybrid Report proposals by NZ.

84 In addition to the difficulties that the OECD proposals cause as regards attraction of FDI, we remain concerned that in a number of respects that we have outlined above the principles underlying the OECD proposals are flawed.

APPENDIX: FOUR EXAMPLES OF THE OECD HYBRID REPORT RULES IN ACTION

The following four examples are taken from the OECD Hybrid Report (here conclusions are just summarised; full analysis is available in the report).

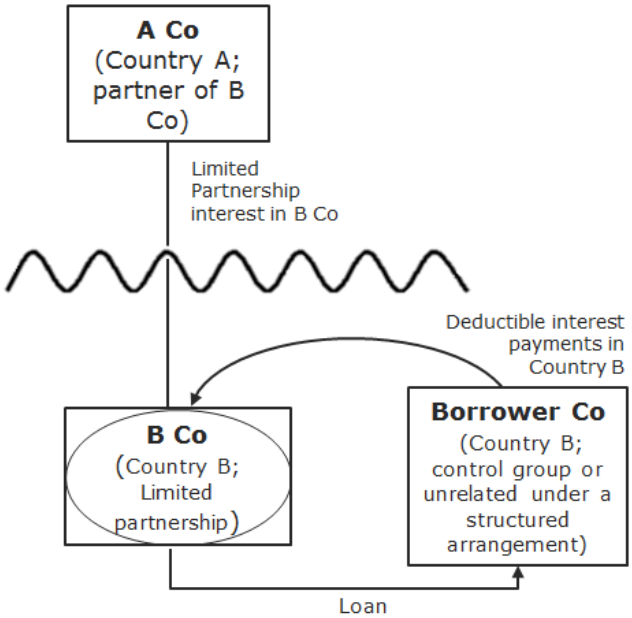
Example 1: OECD Hybrid Report Example 1.1 (page 175) — Interest payment under a debt/equity hybrid



If Country A treats the payment from B Co as a tax-exempt dividend (i.e. Country A does not adopt Recommendation 2 of the OECD Hybrid Report and does not have a rule equivalent to NZ's section CW 9(2)), Country B would apply the hybrid financial instrument rule to deny B Co's interest deduction.

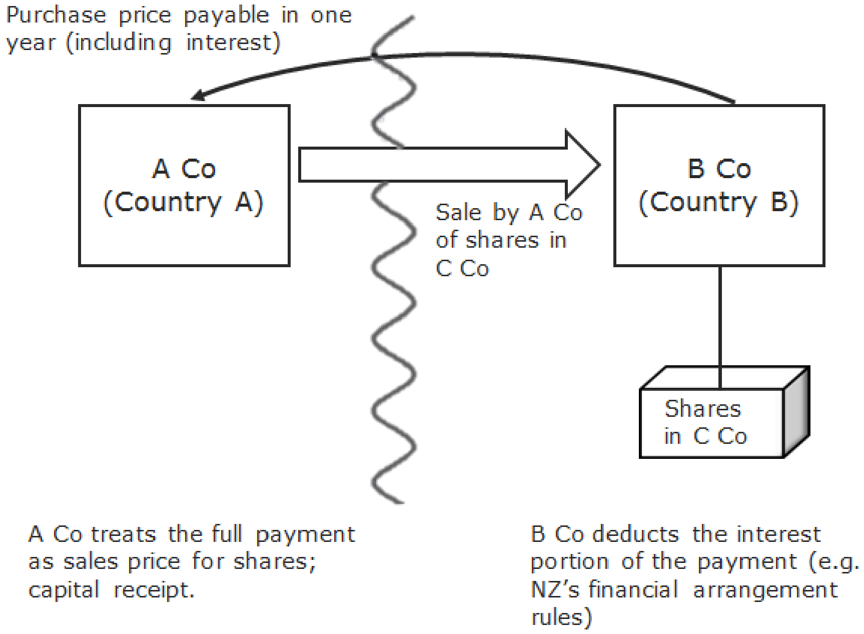
If Country A adopts into its domestic law Recommendation 2 of the OECD Hybrid Report (i.e. a rule equivalent to NZ's section CW 9(2)), Country A would tax the payment on the hybrid loan. As a result, Country B will allow B Co the tax deduction for the interest payment.

Example 2: OECD Hybrid Report Example 4.1 (page 299) — Use of a reverse hybrid



If A Co under Country A tax law treats the interest payments as derived in Country B (i.e. under Country A tax law, B Co is a separate entity) and B Co under Country B tax law treats the interest payments derived in Country A (i.e. under Country B tax law, B Co is transparent), there will be no recognition of income in either jurisdiction. In this situation, Country B would apply the reverse hybrid rule to deny Borrower Co's interest deduction.

Example 3: OECD Hybrid Report Example 1.27 (page 246) — Interest component of purchase price

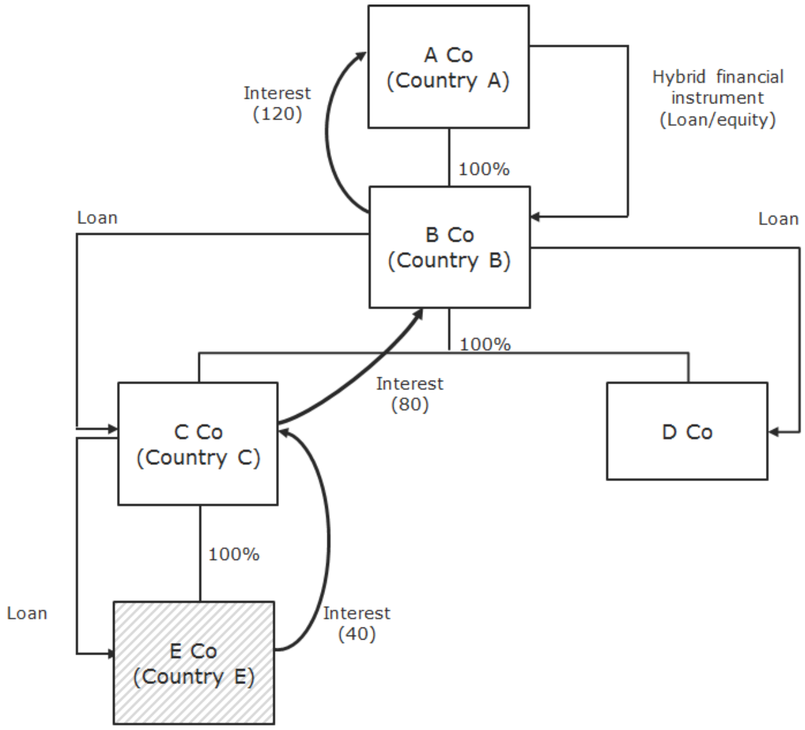


Because B Co claimed an interest deduction which was not matched by a corresponding ordinary income receipt for A Co, Country B would apply the hybrid financial instrument rule to deny B Co's interest deduction. If Country B has not implemented the hybrid financial instrument rule, or does not counteract the mismatch, Country A would apply the defensive rule and include that interest payment in the ordinary income of A Co. This result applies even if A Co has included the full purchase price (including the amount that from Country B's perspective is the interest component) in its amount realised and on which capital gains tax is paid under the laws of Country A.

As suggested by NZ's Discussion Document (at paragraph 5.29), if A Co was a trader and included the entire payment in their ordinary income, the hybrid financial instrument rule could still be applied by Country B to deny B Co's deduction. This is because "the application of the rules depends on the tax treatment of a payment of "ordinary status,""[34] i.e. B Co could be treated as if it was dealing with entities as holding the shares on capital account. In that situation, there is no actual D/NI outcome, but because one could have theoretically existed, B Co will still be denied an interest deduction.

34 At 5.29.

Example 4: OECD Hybrid Report Example 8.1 (page 341) — Structured imported mismatch rule



In this situation, A Co and B Co are parties to a hybrid financial instrument. By way of on-lending arrangements between B Co and C Co, and then C Co to E Co, OECD's Hybrid Report suggests that the hybrid mismatch occurring between A Co and B Co is 'imported' into Country E, i.e. irrespective of whether E Co's interest deduction is matched by interest income by C Co in Country C, E Co's interest deduction in Country E is viewed as offset at the group level by the hybrid mismatch between A Co and B Co under the laws of Country A and Country B. In this situation, Country E would apply the imported mismatch rule to deny E Co's interest deduction even though the hybrid mismatch between A Co and B Co does not affect Country E's tax base. (Note: This rule appears to be premised on an ability to trace funds through different jurisdictions. If as is almost inevitably the case, the group operates via a centralised treasury function under which moneys are fungible it appears that the imported mismatch rule does not apply. With a hole this large, the question arises as to whether the rule should be introduced at all.)