

In confidence

Office of the Minister of Finance  
Office of the Minister of Revenue

Cabinet Economic Growth and Infrastructure Committee

## **BEPS – addressing hybrid mismatch arrangements**

### **Proposal**

1. This paper seeks Cabinet approval to introduce new tax rules to address the problem of hybrid mismatch arrangements. This paper is part of a comprehensive package of measures to address base erosion and profit shifting (BEPS).

### **Executive summary**

2. Hybrid mismatch arrangements are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

3. The OECD, as part of its base erosion and profit shifting (BEPS) Action Plan, published in late 2015 its final report on hybrid mismatch arrangements. This report recommended that countries enact a comprehensive set of rules to neutralise the benefit of hybrid mismatch arrangements affecting their tax base.

4. The UK has legislated the OECD recommendations into their domestic law and Australia is committed to do the same. The EU has also issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

5. The OECD recommendations will not apply to the vast majority of taxpayers. They will not apply to purely domestic firms. They apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of the OECD recommendations is that the tax benefit of hybrid mismatch arrangements is eliminated, in most cases influencing taxpayers to switch to more straightforward cross-border financing instruments and structures.

6. The Government released a discussion document in September 2016 called *Addressing Hybrid Mismatch Arrangements* which proposed that the OECD recommendations be adopted in New Zealand and asked for feedback on how that should best be done. Since receiving submissions to this document, officials have engaged stakeholders in targeted consultation on specific design issues relating to the proposal. Consultation has resulted in some of the proposals being modified, such as a proposed exclusion from the rules for New Zealand businesses that operate offshore only through a simple branch structure. Nevertheless, many taxpayers affected by these proposals will still oppose them. Some would prefer to see a targeted approach, which would only tackle hybrids that have already been observed in New Zealand.

7. However, in order to send the clear message that using hybrid mismatch arrangements should not produce a tax advantage, we are recommending that Cabinet agree to a comprehensive adoption of the OECD recommendations on hybrid mismatch arrangements with suitable modifications for the New Zealand context. To do otherwise may simply encourage the ongoing use of hybrids not covered by any targeted proposal. Other issues raised through the consultation process, and which are likely to attract the most comment (such as the application of the rules to foreign trusts) are set out in paragraphs 24-38 of this paper.

8. We are further recommending that hybrids rules be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

## **Background**

### ***BEPS***

9. New Zealand's BEPS work programme has largely been driven by a wider momentum that has developed since 2012, when the OECD/G20 began work on their BEPS Action Plan. Its final package of reports was released in October 2015. The Action Plan is a multifaceted approach intending to encourage countries to close many (but not all) of the avenues multinational companies currently use to reduce their worldwide tax liability, and to improve the information available to governments when they deal with multinational companies, without changing the fundamental principles for the taxation of international trade and investment.

10. As a member of the OECD Council, New Zealand approved the 2015 BEPS final package and has supported the BEPS Action Plan since the OECD's first declaration on BEPS in 2013.

### ***Hybrid mismatch arrangements***

11. Hybrid mismatch arrangements are a significant base erosion and profit shifting (BEPS) strategy used by some multinational companies to pay little or no tax anywhere in the world on some or all of their income. They are, broadly speaking, cross-border arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries to achieve double non-taxation.

12. One way in which this double non-taxation can arise is through a payment being deductible for a payer in one country but not included as taxable income for the payee in the other country. Another way double non-taxation can arise is by way of a single payment being deducted against different income streams in two countries.

13. Double non-taxation of this kind is difficult to deal with, because it can be achieved even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues. It is often difficult to determine which of the countries involved has lost tax revenue through the use of a hybrid mismatch arrangement, but there is undoubtedly a reduction of worldwide tax paid.

### *The OECD's response*

14. The OECD has made a number of recommendations as to how countries can improve their domestic rules to prevent mismatches arising and neutralise their effect when they do arise. These recommendations relate to Action 2 of the OECD/G20 BEPS Action Plan: Neutralising the Effects of Hybrid Mismatch Arrangements.

15. The OECD recommends two kinds of rules. The first are rules specifically designed to reduce the likelihood of hybrid mismatches arising. The second are “linking rules”, which apply to payments that give rise to a deduction in more than one country, or which give rise to a deduction in one country but are not taxed as income in another country due to a hybrid mismatch. These generally only apply to:

- arrangements between related parties (25% or more commonly owned) or control groups (50% or more commonly owned); or
- structured arrangements - generally, arrangements between non-associated parties which intentionally exploit such mismatches.

16. These linking rules are divided into “primary” and “secondary” responses. Primary responses have precedence, with secondary responses being used if the country that has the primary right does not have hybrid rules. This primary/secondary structure is important for ensuring that all hybrids with a connection to New Zealand are effectively countered irrespective of where the counterparty is based.

17. The OECD has also developed an additional BEPS Action 2 report that makes a number of recommendations as to how countries can deal with the problem of branch mismatch arrangements which is closely related to the hybrid mismatches issue.

### *Other countries*

18. The UK has introduced into its domestic law rules that reflect a broad adoption of the OECD recommendations. Australia has proposed to do the same and, as part of its 2017 Budget, committed to introduce rules that are effective by 1 January 2018 or six months following Royal assent.<sup>1</sup> The EU has issued a directive requiring its 28 member states (including the UK) to introduce anti-hybrid rules by 1 January 2020. We are not aware of any other countries intending to adopt a comprehensive set of rules, although many countries have more targeted anti-hybrid rules.

### *Hybrids discussion document*

19. On 6 September 2016, the Government released a discussion document entitled “Addressing hybrid mismatch arrangements” seeking feedback on proposals to address hybrid mismatch arrangements in line with the OECD recommendations [CAB-16-MIN-0442].

20. 20 submissions were received on the discussion document. Most submitters accepted the need for some hybrid rules, with some submitters expressing support for New Zealand to take action in line with the OECD hybrids package, subject to various provisos, including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions for hybrid regulatory capital. The majority of submissions argued that we should only implement rules to counter hybrid mismatches actually observed in New Zealand, rather than the full suite of OECD recommendations.

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<sup>1</sup> As set out in paragraph 59, Australia has indicated that it is unlikely to implement OECD recommendation 5 at this stage, but may do so in the future if integrity concerns arise.

## Comment

### *Implementing the full OECD hybrids package*

21. As set out in the cover Cabinet paper (*Tax measures to counter base erosion and profit shifting*), we are recommending that Cabinet agree to a comprehensive implementation of the OECD’s proposed solutions to the hybrid and branch mismatch problem, even though there was limited evidence of some of the structures being used in New Zealand. We are of the view that the OECD proposals are in New Zealand’s best interests, as enacting these recommendations will improve fairness, reduce harmful distortions in investment patterns, increase tax revenue, and will also address the risk of taxpayers using new hybrid mismatch opportunities if only the more common techniques are addressed initially.

22. In making this recommendation, we recognise that these proposals involve considerable complexity, which will not generally be welcomed by those taxpayers affected. However, we are comfortable that there are a number of factors that outweigh these concerns:

- We are proposing to modify the OECD recommendations when it is appropriate to do so for the New Zealand context. Examples are ensuring New Zealand companies with simple foreign branch structures are not caught by the rules (see “application of hybrids rules to foreign branches” below), not applying the rules to purely domestic firms, and not introducing rules when an adequate New Zealand provision already exists.
- We are recommending that officials continue to consult on a few particular issues that have the potential to ease the compliance costs of the proposals before we make a final decision on them under Cabinet delegated authority. These consist of elective options which would in effect allow existing hybrids to be treated as simple equity investments.
- Despite the necessary complexity, the underlying principle is clear – using hybrid mismatches as a tax-efficient means of inbound, outbound or conduit investment is not appropriate.
- We are recommending that relevant parties be consulted on exposure drafts of key aspects of the legislation. This is intended to facilitate workable legislation that is understandable to those applying it.
- In almost all cases, the complexity will be optional. Taxpayers can avoid having to deal with these rules by undertaking simple debt or equity funding.

23. Some of the other more significant issues relating to this proposal are set out below. Those are followed by a brief explanation of each of the OECD recommendations and the principles behind them. The appendix contains a series of detailed aspects of the proposals that we are also seeking Cabinet’s agreement to. These details have been consulted on with interested parties, and are consistent with the general recommendations set out below.

## Significant issues

### *Foreign trusts*

24. As set out in the cover Cabinet paper, we are recommending that foreign trusts be included within the scope of these rules in circumstances where their treatment outside of New Zealand means income of the trust is not included in a tax calculation anywhere in the world. This is not because they are foreign trusts, but because in those circumstances they are “reverse hybrids” according to the OECD recommendations (see the discussion on OECD Recommendation 5.2, below). The same rule would equally impose tax on New Zealand limited partnerships that fit within the reverse hybrids definition.

25. We are aware that foreign trusts have recently had a new set of disclosure rules apply to them following the 2016 Government Inquiry into Foreign Trust Disclosure Rules. In this respect, adding another regulatory regime to the industry now is unfortunate timing. To reflect the fact that these trusts have recently undergone significant compliance costs, and to give the foreign trust and limited partnership industries more time to understand the implications of the proposed rules, we are recommending a delayed effective date for New Zealand reverse hybrids of 1 April 2019.

### *Application of hybrid rules to foreign branches*

26. The way in which the OECD recommendations are written would in some circumstances deny a New Zealand company the ability to offset a loss from its foreign branch against its New Zealand income. This is an issue that some submitters have been very concerned about.

27. We have made various modifications to the OECD recommendations to address this issue, including clarifying that taxpayers who have simple offshore branch structures do not present a hybrid mismatch problem and so are not covered by the rules.

### *Imported mismatches*

28. OECD recommendation 8 suggests countries include an “imported mismatch” rule when implementing hybrid and branch mismatch rules. Imported mismatch rules apply when the New Zealand resident is not directly involved in the hybrid mismatch, but the benefit of a mismatch is “imported”. Some submitters on the discussion document viewed this particular recommendation as over-reach, highly complex and impractical.

29. To address these concerns, we recommend that the introduction of the imported mismatch rule be different for “structured” and “unstructured” arrangements. Structured arrangements are deliberately entered into to obtain a tax advantage, so should be implemented at the same time as the rest of the hybrid rules. By contrast, unstructured arrangements are ones where the New Zealand benefit is not the primary reason for entering into the arrangement. We recommend that the unstructured rule has a delayed implementation date of 1 January 2020. By this date, we expect that the EU countries, the UK, and Australia will all have hybrid rules. Delaying the implementation of the unstructured rule until those countries have similar rules will reduce the costs involved in complying with the rule in New Zealand because, by that time, multinationals that are also operating in those countries should already be complying with their equivalent rules, and also because payments

to those countries will not be subject to the imported mismatch rule at all. More details regarding the imported mismatch rule are contained later in this paper.

#### *Over-taxation by reason of the imposition of NRWT*

30. The OECD recommends that countries apply the hybrid rules without regard to any withholding tax collected on the relevant payments. In situations where New Zealand imposes non-resident withholding tax (NRWT) on an interest payment that is also denied a deduction under the hybrid rules, there may be over-taxation.

31. As far as our officials are aware, Australia is not planning on departing from the OECD approach. An argument for this approach is that in the majority of cases taxpayers can simply switch to simpler structures and arrangements and be subject to only single taxation. The OECD approach is also less complicated. Nevertheless, there has been an argument from some submitters that the hybrid rules should be modified in New Zealand so as to remove this potential over-taxation for taxpayers that choose to remain in hybrid structures.

32. We recommend that in the case of a hybrid financial instrument, there needs to be further consideration of the possibility of letting taxpayers treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We recommend that Cabinet delegate the authority to determine the appropriateness of such an approach to us to decide after receiving further advice. For hybrid arrangements other than financial instruments, we are less concerned about the imposition of NRWT. Although there may be some over-taxation, in many cases this will simply be a timing issue.

#### *Grandparenting for certain instruments issued by banks to the public*

33. We recommend that there be an exception to the rules for certain hybrid instruments (“hybrid regulatory capital”) issued by banks and insurance companies either directly or indirectly to third party investors, in partial satisfaction of the capital requirements imposed on those companies by regulators (such as the Reserve Bank and its Australian equivalent, APRA). We recommend that such instruments issued before the date of the discussion document release (6 September 2016) should not be subject to the hybrid rules until the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

34. This grandparenting date is different to the date proposed in Australia, which is 8 May 2017 (the day before their Federal Budget). We consider differing from Australia is justified in this case. The Australian Government had made public the fact that it was considering how such instruments should be taxed, and did not make an announcement until its 2017 Budget. In New Zealand the hybrids discussion document released on 6 September stated that such instruments would be subject to the hybrid rules. To grandparent instruments issued after the New Zealand discussion document may be seen as encouraging taxpayers to enter into aggressive structures after the government has stated an intention to change the rules but before that change is enacted. We are wary of creating an expectation that such arrangements will be grandparented.

#### *Opaque election for foreign hybrid entities*

35. The private sector has proposed that a New Zealand investor in a foreign hybrid entity be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand to remove the hybridity and put that entity outside the scope of the rules. Our initial view is that

excluding simple branch structures from the rules, and the ability of hybrid participants to restructure their arrangements, may make such an election redundant. Nevertheless, we have asked officials to continue their consideration of how such an election may work in practice, including whether the costs of administering it for what may be a relatively small group are justified. We recommend that Cabinet delegate to us the authority to decide on the appropriateness of an opaque election.

#### *Application of rules to branch mismatch arrangements*

36. Consultation on branch mismatches has taken place but has not been as comprehensive as that for the remainder of the hybrid proposals. In part this is because such mismatches are less significant for New Zealand, and in part because the OECD draft report on branches was released at around the same time as the New Zealand discussion document, and the proposal was therefore less well developed. Nevertheless, we recommend that New Zealand implement rules that are consistent with the OECD recommendations on branch mismatches (this is also consistent with the approach that has been taken by the UK and which we understand will be taken by Australia). Branch mismatches arising from foreign branch losses are a double non-taxation risk and to leave them out of these proposals would expose the tax base to future risk. The remainder of the branch mismatch concerns addressed are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

#### *De minimis rule*

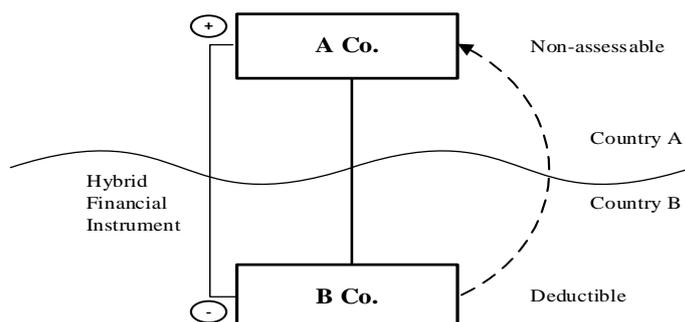
37. We recommend that there be no general de minimis for the hybrid rules. We believe that a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules. This means that any de minimis would likely be ineffective in practice because the other country would still counter the hybrid mismatch using their secondary response right. Also, our proposals will ensure that simple branch structures (the most likely beneficiaries of a de minimis) are not within the scope of the rules.

38. We do however recommend that there should be specific de minimis rules for reverse hybrid entities established in New Zealand (see paragraphs 55-57).

### **OECD recommendations**

#### ***Hybrid financial instrument rules (Recommendations 1 and 2)***

39. The following diagram illustrates a typical hybrid financial instrument issued between related parties A Co and B Co.



40. Double non-taxation arises in this situation because the payment on the hybrid financial instrument is deductible (as interest) in Country B but not taxable (because it is treated as an exempt dividend) in Country A.

41. OECD recommendation 2 is a specific recommendation that countries should amend their domestic law so that dividend payments that are deductible to the payer (B Co) should be treated as ordinary income for the payee (A Co).

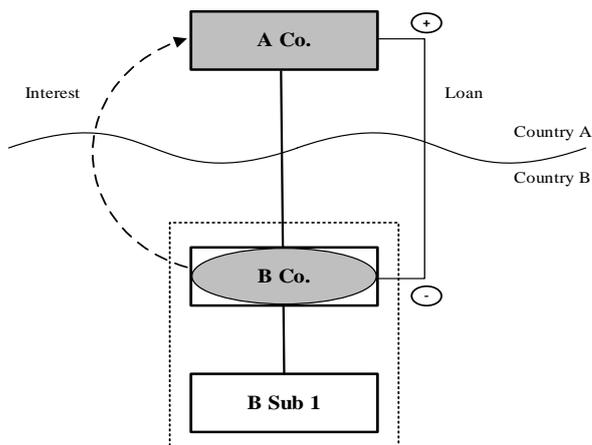
42. New Zealand already has a rule that switches off the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. We recommend that this rule be expanded to also apply if the foreign payer receives tax benefits similar in nature to a deduction.

43. We also recommend introducing rules in line with the general principles of OECD recommendation 1. This means that, in relation to hybrid financial instruments that are structured or between related parties, we should deny a New Zealand payer a deduction for the payment (when New Zealand is Country B) to the extent it is not taxed to a non-resident payee. It is in respect of this aspect of recommendation 1 that we are considering the election to treat interest payments as dividends. In addition, when New Zealand is Country A and Country B does not have hybrid rules, we should tax the New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit.

44. We also recommend that when there is a timing mismatch that allows a deduction to be claimed in one country in a period that is significantly earlier than the period in which income is included in the other country, the rules above should also apply.

### ***Disregarded hybrid payments rule (Recommendation 3)***

45. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor (Country A) but opaque for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the hybrid entity.



46. The interest payment by B Co is deductible in the hybrid entity country (Country B) but disregarded in the investor country (Country A) because Country A sees B Co as being part of A Co and therefore not capable of making a payment to itself. However, as the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can

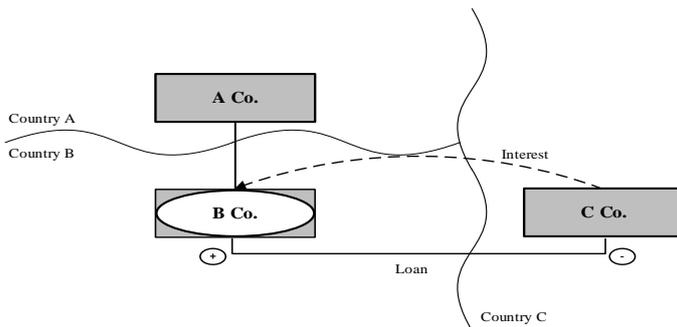
therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

47. We recommend introducing rules in line with the general principles of OECD recommendation 3 in order to prevent double non-taxation arising from a payment by a hybrid entity. We recommend that, when New Zealand is Country B and payments are deductible here but are disregarded for tax purposes in Country A (and the payments are part of a structured arrangement or made to a person in the same control group), we should deny a deduction for the payment. Similarly, if New Zealand is Country A and the non-resident payer in Country B has not been denied a deduction for the payment under similar rules, we should tax the receipt by the New Zealand payee as ordinary income.

48. We recommend that deductions denied and income included by the above rules should be reversible to the extent that the hybrid entity has earned “dual inclusion income”, being income taxed in both Country A and Country B. This is because this dual inclusion income is included as income in both countries so the corresponding deduction should also be allowed in both countries. The dual inclusion income can be earned in the same period as the payment is made, in an earlier period, or in a later period.

#### ***Reverse hybrid rules (Recommendations 4 and 5)***

49. A reverse hybrid entity is an entity which is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In the following diagram, B Co is the reverse hybrid.



50. If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co.

51. We recommend introducing rules in line with the general principles of OECD recommendation 4 to prevent double non-taxation arising from a payment to a reverse hybrid. We recommend that, when New Zealand is Country C, the New Zealand payer be denied a deduction for a payment to a reverse hybrid if the payment would have been taxed if paid directly to the investor (A Co). This rule would only apply when the payer, payee and investor are all in a control group or the payment is part of a structured arrangement.

52. OECD recommendation 5.1 is that countries should change their domestic law so that they tax residents on income not taxed in another country due to its being earned by a reverse hybrid. In other words, when New Zealand is Country A, we should tax A Co on the income of B Co if Country B does not tax it (because it treats B Co as transparent for tax purposes).

53. We recommend that New Zealand should have rules that are in line with the general principles of recommendation 5.1 and other international tax principles. New Zealand already has controlled foreign companies (CFC) rules that in most cases would prevent a reverse hybrid entity mismatch outcome from occurring when a New Zealand resident is the investor (A Co). We recommend that Cabinet delegate authority to us to determine whether our current CFC rules should be enhanced to deal with any forms of reverse hybrid income not currently dealt with, in line with the general principles of recommendation 5.1.

54. OECD recommendation 5.2 is that countries should change their domestic law so that they tax income which is earned by a reverse hybrid entity established in their country. So, when New Zealand is Country B, we recommend introducing rules in line with the general principles of this recommendation. As set out in the cover Cabinet paper and in paragraphs 24-25, this will require amendments to existing law regarding New Zealand limited partnerships and foreign trusts, which can be reverse hybrid entities depending on the tax treatment in the investor country.

55. In regards to limited partnerships, we recommend taxing the partnership income of a non-resident partner if they are in a control group with the partnership and not taxed on their share of the partnership income because their jurisdiction views the income as earned by the partnership as a separate taxpayer from the partner. This rule will only apply if the limited partnership has total foreign-sourced income of greater than \$10,000 or 20% of its total income. This de minimis rule, and the corresponding one for foreign trusts in the following paragraphs, is consistent with the recently-enacted de minimis rule for foreign sourced income of look-through companies.

56. In regards to foreign trusts, we recommend taxing the foreign-source trustee income of the trust, provided that the non-resident settlor and trust are all in a control group. Many family trusts would meet this requirement. Foreign source trustee income will only be taxed if the non-resident settlor is not taxed on the trustee income in their residence country simply because the income is earned by the New Zealand trustee rather than the settlor directly. This rule will only apply if the trust has total foreign-sourced income of greater than \$10,000 or 20% of its total income.

57. We also recommend taxing the foreign-source beneficiary income of a non-resident beneficiary of a foreign trust if they are not taxed on the income in their residence country because that country views the income as earned by the trustee and not the beneficiary. This rule will only apply if the trust has total foreign-sourced income of greater than \$10,000 or 20% of its total income, and the non-resident beneficiary is part of a control group with the trust/trustee. In relation to both beneficiary and trustee income, tax would only be imposed if there was no-one else in the same control group required to include that income in their taxable income.

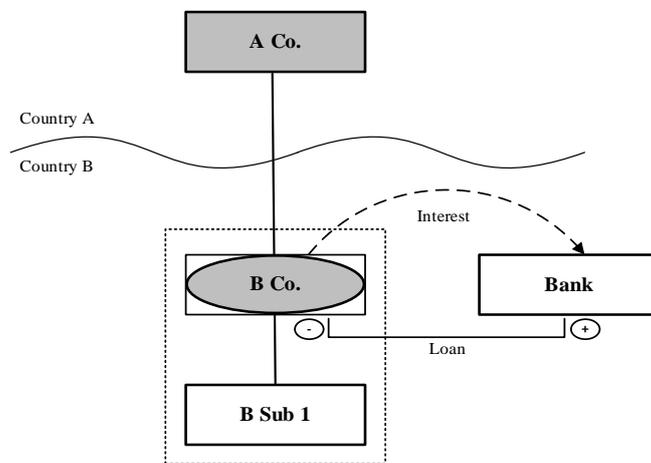
58. OECD recommendation 5.3 is that countries should consider improvements to record keeping and disclosure rules for tax transparent entities established in their country. Following the 2016 Government Inquiry into Foreign Trust Disclosure Rules, the disclosure rules for foreign trusts have been enhanced. New Zealand is regularly reviewed by the OECD to ensure that we are meeting international standards in this area. The Government will

continue to work with the OECD and make improvements to disclosure rules as necessary to ensure compliance with best practice.

59. We note that Australia has indicated that it is unlikely to implement any of recommendation 5 at this point – this is largely because they see their existing rules as adequate. However, they have reserved the right to do so in the future if integrity concerns arise. We are not as confident that our existing rules in relation to reverse hybrids are adequate to prevent mismatches from occurring. As set out above, we are concerned that leaving ‘gaps’ in our rules exposes our tax base to risks that can be mitigated by following all of the OECD’s recommendations.

***Hybrid entities – double deductions (Recommendation 6)***

60. In addition to being capable of generating a deductible/non-inclusion hybrid mismatch, a hybrid entity can also be used to generate a double deduction mismatch. A diagram illustrating this possibility follows, where B Co is the hybrid entity.



61. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co’s other income. In Country B the interest payment can offset income earned by B Sub 1, which is in a tax consolidated group with B Co. This is a double non-taxation outcome because a single payment has been deducted against different income in two countries.

62. In Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand [CAB-17-MIN-0164]. This means that, when New Zealand is Country A, the deductions in B Co would not flow back to New Zealand if it is possible for that deduction to also offset Country B income that does not flow back to A Co (in this case, the income of B Sub 1).

63. Nothing in this paper is inconsistent with that specific decision. However, as mentioned in paragraph 26-27, we are recommending a slightly narrowed approach to the OECD recommendation 6, whereby simple structures involving a New Zealand company with only an offshore branch would not fall within the scope of the rules.

64. We also recommend implementing a rule that would, when New Zealand is Country B, disallow the losses of a foreign-owned New Zealand hybrid entity or branch when the country of the owner (Country A) has not denied the loss.

65. As with the recommendation 3 rule, denial of a deduction under the recommendation 6 rule should be reversed to the extent that the hybrid entity has dual inclusion income, whether in the current period, an earlier period, or a later period.

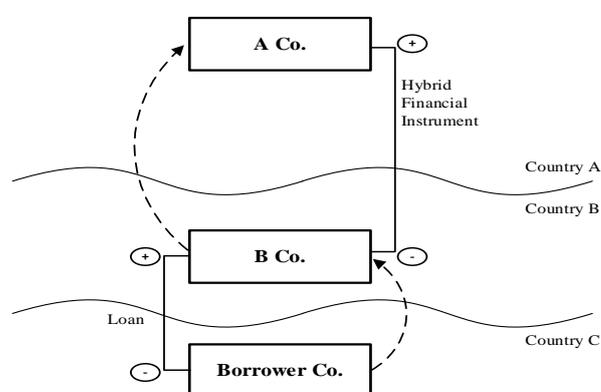
### ***Dual resident entities (Recommendation 7)***

66. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. Expenditure incurred by a company that is a resident of two different countries can potentially be used in each country to offset non-dual inclusion income, which is income taxed only in that country. This would achieve the same double deduction outcomes that hybrid entities can produce under recommendation 6 (above).

67. New Zealand tax law already prevents a dual resident company from grouping its losses or forming a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (potentially) a New Zealand limited liability partnership. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

### ***Imported mismatches (Recommendation 8)***

68. As set out in paragraphs 28-29, we recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment that funds another payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



69. In this example, New Zealand is Country C. The loan between A Co and B Co generates a deduction in Country B, with no corresponding income inclusion in Country A. This is a double non-taxation outcome. However, this tax mismatch is not counteracted because neither Country A nor Country B has hybrid rules. The tax benefit of the A/B mismatch helps fund the seemingly benign arrangement between B Co and the New Zealand entity (Borrower Co).

70. The imported mismatch rule would require New Zealand, as Country C, to deny a deduction for interest payments from Borrower Co to B Co to the extent they do not exceed the payments under the hybrid financial instrument between B Co and A Co. This is an integrity measure that prevents New Zealand's other hybrid rules from being circumvented.

Without this rule, businesses in Country A can simply avoid our proposed rules by going from A to C via B.

71. We recommend that the imported mismatch rule applies to both structured arrangements that are designed to produce an imported mismatch outcome, and unstructured arrangements within a control group. However, because unstructured arrangements may not be deliberately contemplated, we are recommending a delayed implementation for those arrangements until more countries, the EU countries in particular, have hybrids rules in place.

### Agency consultation

72. The consultation on this project has been explained in the cover Cabinet paper. Briefly, there have been two rounds of consultation: one on the proposals in the discussion document; and a further round with selected submitters on branch mismatches and some of the detailed aspects set out in this paper.

### Financial implications

73. The proposed hybrid rule denying double deductions for foreign hybrid entities is estimated to increase tax revenue by \$50 million per year from the 2019-20 year onwards. These amounts are already included in the forecasts as per Budget 2017 (CAB-17-MIN-0164).

74. In addition, the proposed approach to grandparenting certain hybrid instruments as discussed at paragraphs 33-34 is expected to generate a total of \$71 million over four years which is not currently included in the forecasts. This revenue is contingent on taxpayer behaviour after the implementation of the hybrid rules.

75. The combined revenue impact of all proposals is estimated as:

\$ million – increase / (decrease)							
<b>Vote Revenue</b>	<b>2016 /17</b>	<b>2017 /18</b>	<b>2018 /19</b>	<b>2019 /20</b>	<b>2020 /21</b>	<b>2021 /22</b>	<b>2022/23 and out years</b>
Foreign hybrid entity double deductions (already included in forecast)	0	0	25	50	50	50	50
Hybrid instruments – grandparenting (new adjustment to forecasts)	0	0	19	19	19	14	0
<b>Total revenue effect</b>	<b>0</b>	<b>0</b>	<b>44</b>	<b>69</b>	<b>69</b>	<b>64</b>	<b>50</b>

### Human rights, administrative impacts, legislative implications, publicity

76. These are set out in the accompanying covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).

## Impact Analysis Requirements

77. Cabinet's Impact Analysis Requirements apply to these proposals and a Regulatory Impact Assessment is required. This has been prepared by Inland Revenue and is attached.

78. The Quality Assurance reviewer at Inland Revenue has reviewed the Regulatory Impact Assessment and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.

## Recommendations

79. We recommend that Cabinet:

1. **Agree** that for payments under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:
  - a. to deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (OECD recommendation 1 primary rule); and
  - b. if a non-resident payer has not been denied a deduction for the payment under similar rules, to tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (OECD recommendation 1 defensive rule).
2. **Agree** to expand New Zealand's current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (OECD recommendation 2).
3. **Agree** that for payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognised under the tax law in the payee country because the payment is disregarded under that law:
  - a. to deny a deduction for the payment if made by a New Zealand payer (OECD recommendation 3 primary rule);
  - b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, to include the payment in ordinary income of the New Zealand resident (OECD recommendation 3 defensive rule);
  - c. to allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against income that is included as income in both relevant countries ("dual inclusion income").
4. **Agree** to deny a New Zealand payer a deduction in relation to payments made to a reverse hybrid entity in the same control group as the payer or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid entity (OECD recommendation 4).

5. **Agree** that New Zealand should tax the income of a reverse hybrid established in New Zealand (such as a foreign trust or a limited partnership) to the extent that:
  - a. the reverse hybrid income is not subject to tax in another jurisdiction (OECD recommendation 5.2); and
  - b. the total foreign sourced income of the reverse hybrid exceeds the greater of \$10,000 or 20% of the total income of the reverse hybrid.
  
6. **Agree** to the following in relation to double deduction outcomes produced by branches and hybrid entity structures:
  - a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branch if there is another entity in that foreign country whose income is capable of being offset against the losses of the hybrid entity or branch and that income is not taxable in New Zealand (modified OECD recommendation 6 primary);
  - b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (OECD recommendation 6 defensive); and
  - c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.
  
7. **Agree** to deny a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income (OECD recommendation 7).
  
8. **Agree** to deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, except to the extent that the payment is made to a country that has hybrid mismatch rules (OECD recommendation 8).
  
9. **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.
  
10. **Agree** that the effective date of the rule relating to unstructured imported mismatches (part of recommendation 8 above) should be delayed until 1 January 2020.
  
11. **Agree** that the application of the rule relating to New Zealand reverse hybrids (recommendation 5 above) should be for income years beginning on or after 1 April 2019.
  
12. **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:
  - a. issued to satisfy the regulatory capital requirements imposed by New Zealand or Australian law;
  - b. directly to, or are traceable to, issues to the public; and
  - c. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

13. **Note** that the fiscal consequences of agreeing to recommendation 12 above is set out in the covering Cabinet paper for the overall BEPS package (*Tax measures to prevent base erosion and profit shifting*).
14. **Agree** to the detailed design proposals set out in the appendix to this paper.
15. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on further detail of these proposals, or to amend the detail in the appendix, provided any such decisions are not contradictory with the principles set out in recommendations 1 to 12, without further reference to Cabinet.
16. **Agree** to delegate authority to the Minister of Finance and the Minister of Revenue to make final policy decisions on the following policy issues without further reference to Cabinet:
  - a. whether New Zealand's controlled foreign company (CFC) rules should be modified to include as attributable foreign income all income of a reverse hybrid entity which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is treated as fiscally transparent in that country (OECD recommendation 5.1);
  - b. whether New Zealand can and should include a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes; and
  - c. whether, the payer under a hybrid financial arrangement for which a deduction is denied, should be allowed to treat the payment as a dividend for purposes of both (but not only one of) the non-resident withholding tax and the imputation credit rules.
17. **Agree** that the results of the decisions in recommendations 1-16 be included in a BEPS taxation bill to be introduced to Parliament before the end of 2017.

Authorised for lodgement

**Hon Steven Joyce**  
Minister of Finance

**Hon Judith Collins**  
Minister of Revenue

## Appendix

### List of detailed design decisions

	<b>OECD Recommendations 1 and 2</b>
1.	A person who receives a payment which is deductible to the payer in another country will not be entitled to the benefit of any imputation credit attached to the payment.
2.	When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency, the deduction denied will take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes, and any net income from the instrument including any foreign currency fluctuations will be non-taxable.
3.	When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the taxpayer will not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.
4.	To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee entity under another country's controlled foreign company (CFC) regime, the payer will be allowed a deduction for the payment.
5.	If a person holds a FIF interest as part of a share repo arrangement, that person will be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest.
6.	If a person holds New Zealand shares as part of a share repo arrangement, where the borrower is a non-resident, the person is not entitled to the benefit of an imputation credit attached to any dividends on the shares.
7.	OECD recommendation 1 will only apply to timing mismatches if: <ul style="list-style-type: none"><li>• the mismatch arises on an instrument with a term of 3 years or more or on an instrument that has been extended to beyond 3 years; and</li><li>• the lender is not accounting for the payment, for tax purposes, on a reasonable accrual basis; and</li><li>• it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months</li></ul>

	of the end of the period in which the expenditure is incurred.
8.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.
9.	Interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.
10.	There will be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

	<b>OECD Recommendation 3</b>
11.	Any foreign currency fluctuations recognised for tax purposes in relation to a financial arrangement denominated in a foreign currency will be taken into account when denying a deduction to a New Zealand payer.
12.	Dual inclusion income will be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it will not include income which is protected from New Zealand tax by a foreign tax credit.
13.	For the purposes of denying a deduction for a New Zealand payer, full taxation of income under a CFC regime will prevent income being treated as not taxable to a payee and will qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.
14.	When an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that will be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible.
15.	The ability to claim a deduction in relation to a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.
16.	Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted.

17.	Denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules.
18.	A deduction would be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs.
19.	Where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income will be reversed in a later year when there is dual inclusion income earned through the hybrid entity.

	<b>OECD Recommendation 4</b>
20.	Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.
21.	Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.
22.	To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.
23.	Non-resident withholding tax will continue to be applied to payments, despite the denial of the deduction
24.	Interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

	<b>OECD Recommendation 5.2</b>
25.	Tax the partnership income of a non-resident partner of a New Zealand limited partnership if the non-resident partner is in a control group with the partnership and the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not by the partner.
26.	Tax a New Zealand resident trustee on foreign-sourced beneficiary income allocated to a non-resident beneficiary as if the trustee were a New Zealand resident individual taxpayer to the extent that: <ul style="list-style-type: none"> <li>• the beneficiary is in the same control group as the trustee; and</li> <li>• the beneficiary would be taxed on income from the assets giving rise to the beneficiary income if it held the assets directly; and</li> <li>• the income is not subject to tax as the income of any person other than</li> </ul>

	the trustee (such as the beneficiary or settlor).
27.	<p>Tax a New Zealand trustee of a foreign trust on foreign-sourced trustee income to the extent that:</p> <ul style="list-style-type: none"> <li>• the settlor is in the same control group as the trustee;</li> <li>• the settlor would be taxed on the trustee income if it held the trust assets directly; and</li> <li>• the income is not subject to tax as the income of any person other than the trustee.</li> </ul>
28.	<p>Include a de minimis so that none of the above recommendation 5.2 rules apply if the total foreign sourced income of the trustee does not exceed the greater of \$10,000 and 20% of the total income of the trust.</p>

	<b>OECD Recommendation 6</b>
29.	<p>There will be a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity.</p>
30.	<p>A deduction will be allowed in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country</p>
31.	<p>Income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit.</p>
32.	<p>Double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch will be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.</p>
33.	<p>The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred or deemed expenditure arose.</p>
34.	<p>Amendments will be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are</p>

	deducted.
35.	Denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	<b>OECD Recommendation 7</b>
36.	Amend existing consolidation and loss grouping rules for dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.
37.	Double deduction amounts and dual inclusion income amounts will be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit will not be regarded as dual inclusion income.
38.	The ability to claim a deduction in relation in a later year due to future dual inclusion income will be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred.
39.	Denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules.

	<b>OECD Recommendation 8</b>
40.	When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied will ignore any foreign currency fluctuations on the instrument.
41.	Interest that is denied a deduction under recommendation 8 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules

	<b>General design and definitional matters</b>
42.	A coordination rule will be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.
43.	A specific anti-avoidance rule will be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.