OLIVERSHAW LTD
TAX SPECIALISTS

Olivershaw Limited
Level 1, Aviation House
12 Johnston Street
WELLINGTON
PO Box 30 504
Lower Hutt 5040
Phone: 04 577 2700
Fax: 04 577 2701

28 October 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
WELLNGTON 6140

Dear David

Re: Addressing hybrid mismatch arrangements – a Government discussion document ("the DD")

This is a submission on the above Discussion Document.

Submission 1 Foreign trusts should not be reviewed as part of the review of hybrid instruments

As you are aware the Government established in April 2016 an Inquiry under section 69(3) of the Inquiries Act 2013 constituting one person, Mr John Shewan. The Shewan Inquiry sought and received submissions on its terms of reference which were broad and policy in nature. The Inquiry reported in June 2016 with detailed recommendations which concluded that New Zealand should retain its existing tax laws relating to foreign trusts but ensure adequate information disclosure.

The Government accepted those recommendations. Our first submission is that there should be no additional changes to the tax regime for foreign trusts given the Government's acceptance of the Shewan Inquiry's findings. Should the Government now wish to revisit this, there should be a detailed analysis of the Shewan Inquiry and which changes should be made that are inconsistent with that Inquiry.

Para 7.29 of the DD

Paragraph 7.29 of the DD states the following:

> There is also an argument in favour of New Zealand taxing the foreign source trustee income of a New Zealand trust to the extent that that income is not taxed in any other country. The non-taxation of foreign-sourced trustee income of a New Zealand foreign trust is premised on the non-residence of the settlor. The trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New

> Zealand's right to tax. Accordingly, if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person.

Recommendation 5.2 of the OECD 2015 Final Report "Neutralising the Effects of Hybrid Mismatch Arrangements" (the OECD report") states:

> A reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.

A reverse hybrid is defined in recommendation 4 of the OECD report and provides:

> A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction.

Submission 2 A foreign trust is not a reverse hybrid

A reverse hybrid is defined in recommendation 4 as stated above. A foreign trust is not transparent for New Zealand tax purposes. Under New Zealand tax legislation, a foreign trust is exempt from New Zealand tax on foreign sourced income. First, this is not transparent, it is not a flow through vehicle. Second, a foreign trust is taxed on New Zealand sourced income. It is not uncommon that a foreign trust has New Zealand sourced income and therefore it has New Zealand tax liabilities. This is clearly not transparent.

Paragraph 7.29 above states that "the trustee income is, in a sense, allocated to the non-resident settlor for the purpose of determining New Zealand's right to tax". As noted immediately above, this is wrong. A foreign trust has both exempt income and taxable income, namely exempt foreign income and taxable New Zealand income. This is not uncommon as many New Zealand entities have both exempt income and taxable income, clearly they should not be considered to be transparent simply due to having exempt income.

For example, New Zealand corporates have exempt income being most dividends received from foreign companies. If a foreign trust is a reverse hybrid, applying the same logic, all New Zealand corporates should also be treated as a reverse hybrid, clearly such an outcome is wrong.

Where a foreign trust earns New Zealand source income, the trustees are taxed on that income.

Given the above, no changes should be made to the existing tax treatment of foreign trusts in New Zealand. The following submissions points are made for completeness as we do not believe a New Zealand foreign trust is a reverse hybrid.

Submission 3 Settlor being part of a control group

As stated in paragraph 7.29, the reverse hybrid rules would only apply where the settlor is in the same control group as the trust. We also note that example 11.1 of the OECD report states the following (emphasis added):

> As settlor of the trust, A has the sole right, under the terms of the trust deed, to appoint trustees, which is **one of the enumerated voting rights** described in the related party rules. The fact that the constitutional documents (in this case the trust deed) do not give A the power to authorise distributions or alter the terms of the trust, **does not affect the conclusion that A holds 100% of the voting interests in the trust**.

Voting rights is defined as (recommendation 12 of the OECD report)

> Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.

As an initial comment we cannot see how having the right to appoint trustees give voting rights in a trust, let alone how any conclusion can be made that that should be 100% of the voting interests. The above OCED comments are not consistent and demonstrate the issues with this. That is, the voting rights refer to the ability to participate in any decision making concerning a distribution, yet example 11.1 states that with the settlor not having any power to authorise distributions does not affect the conclusion that the settlor holds 100% of the voting interests. Clearly, the trustee(s) has (have) the power to make distributions, and hence it is impossible to conclude that someone who has no such power has 100% of the voting interests.

Further complexities will obviously arise where there more than one settlor or where a/the settlor is deceased. For these reasons we cannot see any viable method of applying the control test to most trusts. While we do not believe trusts are transparent, if they were, we can see no basis for concluding that the trust and settlor are in the same control group and therefore conclude that it is not possible to apply the reverse hybrid rules.

Submission 4 – Applying reverse hybrid based on settlor home country tax jurisdiction rules

The DD concludes "if the settlor is in the same control group as the trust, it would seem logical to apply Recommendation 5.2 to tax the trustee income, if it is not taxed to the settlor or any other person".

It certainly does not seem logical to tax trustee income if the settlor is not taxed. The settlor may have no beneficial interest in the trust, hence the tax treatment of the settlor seems irrelevant. For example, there will be situations where settlors are deceased. Presumably they are not then taxed. This should not result in the trustee being taxed.

On the face of it, it seems more logical to consider the tax treatment of the beneficiaries as they will ultimately be the taxpayers who will be taxed should any such amounts be taxed. That then raises the issue of which beneficiary? Most foreign trusts will have a number of beneficiaries, most of whom may be discretionary, and many will not know they are beneficiaries. Some beneficiaries will be charitable and therefore exempt from tax.

We conclude that it is simply not possible to tax trustees based on what the tax treatment is of the settlor or/and beneficiaries.

Submission 5 Basis of taxation

The DD by implication seems to conclude that given, the tax treatment of New Zealand foreign trusts, they are reverse hybrid instruments. For the reasons noted above, we do not believe this is correct.

- Foreign trusts will not be hybrid entities if the country that the settlor/beneficiaries reside in is a country which does not tax foreign income (regardless of the nature of the New Zealand foreign trust).
- Foreign trusts that hold equity instruments in foreign operating companies are unlikely to give rise to any tax even if the settlor or beneficiary held those shares directly.
- Many foreign trusts do not earn income (profits are simply derived by companies whose shares are held by the foreign trust), when these companies pay dividends to the foreign trust, the foreign trust may make distributions. Many jurisdictions will tax such distributions. It is difficult to conclude why the foreign trust should be seen as a reverse hybrid in such circumstances.
- Applying New Zealand tax legislation could result in the trustee having NZ taxable income (say under the FDR regime) whereas there is no foreign tax under this basis (i.e. FDR regime) to the beneficiaries or settlor, they are likely to be taxed (if there is taxation) simply on distributions. This is not a reverse hybrid.
- A foreign trust that derives New Zealand source income will be taxable on that income in New Zealand.

Submission 6 Compliance costs

The compliance costs of determining whether the reverse hybrid rules apply are likely to be substantial and in most cases no tax will be payable. We refer to the Shewan Inquiry which concluded that our tax settings are appropriate however improvements should be made to the disclosure regime. We concur with that conclusion and note that this is being progressed by the government. We see no benefit in now applying the reverse hybrid rules, noting that we do not think they should apply in any event.

Conclusion

The proposals in the DD affecting trusts are very unclear to the extent that it is not possible to provide useful detailed technical issues. Our fundamental point is that the New Zealand tax treatment of trusts is to treat them as opaque entities (not transparent entities). On that basis they should not be hybrid instruments and should be outside the ambit of this review which should be limited to its subject matter – hybrid entities and instruments.

We note a wider concern which is that the DD seems to be extending the ambit of the hybrid review beyond the already very wide ambit adopted by the OECD. This is reflected in paragraph 7.29 with respect to foreign trusts. The OECD report is explicitly limited to what it describes as deductible/ non-income mismatches in the tax treatment of financial instruments (defined as debt, equity or derivatives of debt and/or equity instruments) and to payments under financial transactions. Thus paragraph 11 states:

> The hybrid mismatch rules focus on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated Action 2 [the hybrids project].

Paragraph 12 notes that mismatches in tax treatment that are attributable to differences in the measurement of the value of payments rather than the character of the payment, can "generally be ignored for the purposes of the hybrid mismatch rules". An example given is where one country provides a deduction for foreign exchange fluctuations but the other country does not tax such income.

Example 1.25 gives the example of a lease treated as a finance lease by the lessor (with taxable income only to the extent of deemed interest) and as an operating lease by the lessee (with deductions for all the payments). The conclusion reached is that the hybrid mismatch rules should not apply to such an arrangement because the country treating the instrument as a financial instrument taxes all the deemed interest as income. This is the case even though the lessee obtains deductions exceeding the interest income taxed to the lessor.

It is clear from the above that the OECD report does no intend the hybrid rules to operate so as to tax income or limit deductions just because an entity is tax exempt or exempt on part of its income. It accepts that an entity may get a deduction for equity (deemed interest) that may not be taxable in the hands of an offshore owner. The equity deduction may offset tax on foreign income the entity derives from another party for whom the payment is tax deductible. The report seems to accept that this does not give rise to a tax mismatch that hybrid rules should target. The report notes that a lease may be treated as a finance lease in one country and an operating lease in another giving rise to deductions that exceed the amount returned by the lessor as income but the hybrid rules will not prevent this.

In other words the OECD report is sensibly not attempting to use the hybrid rules to force the harmonisation of the tax rules of every country in the world. The OECD report recognises that the hybrid rules will not prevent international transactions that can result in lower overall tax than might be the case if all transactions were limited to one tax jurisdiction.

In contrast to the OECD positon the DD, at least with respect to its comments on foreign trusts in paragraph 7.29, seems to suggest that the hybrid rules should be used to, in effect, remove any tax exemptions that New Zealand might apply or any New Zealand tax law that might produce an outcome different to that which would apply if the laws of some other country applied. The suggestions in the DD would even subject to New Zealand tax the income of a trust when the country of the settlor and beneficiary would not tax such income and where the country of source does not tax the income. In other words the OECD hybrid report seems to be advanced to support New Zealand tax applying when no tax would ever arise apart from the existence of a New Zealand resident trustee. We see no basis justifying this approach in terms of either New Zealand's interests or the OECD report.

We are happy to discuss our submission.

Yours faithfully
Olivershaw Limited

Robin Oliver MNZM
Director

Mike Shaw CA
Director