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28 October 2016

Addressing hybrid mismatch arrangements
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue
Wellington 6140

Dear David

Addressing hybrid mismatch arrangements

Thank you for the opportunity to comment on the Government discussion document, *Addressing hybrid mismatch arrangements*. We are grateful for the original ten day extension to the deadline for submissions which was notified to us (but please note our comments below in respect of process and timeframe more generally).

We appreciate the Government's desire to address base erosion and profit shifting (BEPS) that occurs via the use of hybrid entities and instruments. New Zealand is part of a globalised economy and needs to consider its policy settings in that context. We acknowledge that New Zealand needs to protect its global reputation by being a 'good global citizen' and that, as a consequence, the Government should consider the effect on other countries of New Zealand's tax policy settings and any changes to those settings.

However, we are not convinced that adopting the OECD's recommendations for addressing hybrid mismatches in the manner and timeframe envisaged is the correct approach. Rather we are concerned that adoption of the OECD's very broad recommendations as set out in the Discussion Document in the implied timeframe of the next two years or less would be to the detriment of New Zealand businesses and the New Zealand economy generally.

New Zealand's national interest

The proposals seem to be us to be inconsistent with the Government's role of protecting New Zealand's national interests and growing the New Zealand economy to maximise the welfare of New Zealanders.

New Zealand is a capital importer and is comparatively highly reliant on foreign direct investment. If the proposals were implemented in their entirety or in large measure we would be concerned that they would increase the effective tax rate on inbound investment and adversely affect New Zealand's competitiveness and productivity. New Zealand competes with many other countries for inbound investors seeking to invest in key commercial and infrastructure projects. Such projects are critical for economic development and tax policy settings must remain competitive to ensure tax does not hinder such investment or raise the cost of that investment so that it becomes infeasible.

In considering whether to adopt the OECD's hybrid recommendations the Government must be very careful to achieve the appropriate balance between doing what is good for the New Zealand economy and protecting the New Zealand tax base. New Zealand's primary focus should not be on protecting the tax bases of other countries.

Importance of other countries' responses

As noted in the discussion document, the United Kingdom and Australia have indicated their intentions to adopt the OECD's hybrid recommendations as has the European Union in respect of intra-EU arrangements. The Discussion Document does not consider the intentions of the United States, Canada, Japan, China and Singapore, for example, which are all significant sources of inbound investment into New Zealand and the home of important trading partners for many New Zealand businesses.

The indicative timeframe (draft legislation in 2017 and application from early 2018) is such that we believe there is a real risk that New Zealand could end up being a leader rather than a follower in terms of adopting the OECD's recommendations. Given that few New Zealand businesses are likely to drive decision-making within corporate groups about group structures and intra-group funding arrangements, it seems inappropriate for New Zealand to be a pioneer or one of the early adopters of the OECD's recommendations. Such decisions are driven by head offices or regional headquarters based in, for example, the United States, Australia or Singapore.

The OECD's hybrid recommendations are premised on their adoption by a number of countries. Generally in a tax context each country is free to determine its own tax policy settings i.e. national sovereignty is paramount. The hybrid proposals are therefore unusual in the sense that they result in the tax treatment in one country being determined or influenced by the tax treatment in another country. In our view the proposals will achieve the OECD's desired outcome only if they are adopted in many OECD / G20 countries if not all. On the evidence so far it seems likely that many countries, OECD member nations and others, will either not adopt the proposals or will adopt them in part only, or will be late adopters.

The risk that the OECD recommendations are not implemented widely must be factored into New Zealand's response to those recommendations. This risk should not be ignored. As Professor of International Tax Law, Juergen Luedicke, noted in his article in the Bulletin for International Taxation:

> "Why a state should pioneer the introduction of anti-hybrid rules seems to be a particularly difficult and open question since it is unrealistic that the community of states will achieve a level playing field by introducing harmonised anti hybrid rules. One may well expect at least some states to make a decision not to act if they believe that anti-hybrid rules are apt to put their own industry or inbound investments at a disadvantage."[1]

[1] Bulletin for International Taxation June / July 2014, 300

The Government needs to be cognisant of the fact that implementation of the proposals could result in New Zealand taxpayers being denied deductions because of the tax treatment that applies in another country, which may not have adopted the proposals itself.

We are not suggesting that New Zealand should not be a 'good global tax citizen'. Our concern is that New Zealand becomes a leader despite the country's small size and miniscule share of the global tax base for no other reason than to be seen to be making reforms in line with the OECD's recommendations.

The Government needs to bear in mind that the BEPS project including the hybrids recommendations have been driven by countries with significantly larger economies, which are more attractive because they have significantly larger consumer markets and pools of capital. The solutions offered are primarily designed to assist those economies. The size of those economies means that investment is likely to be 'stickier'. New Zealand's economy does not have the same attractiveness.

It is naïve to assume that New Zealand subsidiaries of multi-national companies will be able to determine or influence the tax treatment of arrangements and financial instruments and changes to that treatment in other countries.

The proposals as part of a broader framework

We welcomed the release of the draft Inbound Investment Framework and the strong signal it sent that any changes to New Zealand's tax rules in response to the OECD's BEPS action plan would be considered in the context of a broader framework that focuses on what is good for the New Zealand economy. We were pleased that the draft Framework made it clear that:

- a Government priority is to ensure that New Zealand continues to be a good place to invest;
- New Zealand's tax system has the overarching goal of maximising the welfare of New Zealanders and the Framework should be seen as part of this system;
- a balance needs to be struck between:
  - ensuring that taxes do not unduly discourage foreign investment or increase the cost of capital for New Zealand businesses, and
  - protecting New Zealand's tax base and preventing tax avoidance;
- any proposals to change current policy settings would be considered within an explicit, robust and coherent economic framework.

The Discussion Document makes no reference to the Inbound Investment Framework. This surprises us given the Framework was intended to be the guiding document against which proposals to counter BEPS in New Zealand would be measured.

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Scope and complexity of proposals

The proposals in the Discussion Document are cast very broadly and seem to suggest a fundamental re-think of New Zealand's taxation of inbound and outbound investment. They have implications for many of New Zealand's taxing regimes including the rules that apply to:

- controlled foreign companies
- foreign investment funds
- branches
- thin capitalisation
- withholding taxes
- source and residence
- tax avoidance (New Zealand's general anti-avoidance rule).

The breadth of the proposals is such that they will affect a large number of taxpayers and will have implications for many ordinary business dealings, including, for example, for every taxpayer operating a foreign branch. The potential scope of the proposals is not limited to large multi-national businesses. The proposals will also affect SMEs, partnerships and individual taxpayers.

The Discussion Document does not appear to set out the proposed limits of the hybrid project. Paragraphs 4.7 and 4.8 refer briefly to some of the OECD limitations. In our view the Government should confirm upfront as an underlying principle that the scope of the project is limited to financial arrangements (equity, debt and derivatives) and payments under such instruments. It should confirm that finances leases and any tax exemptions New Zealand may provide in whole or in part are outside the scope of the project.

The proposals are also extremely complex. The Discussion Document is 83 pages and it effectively recommends the adoption of the 450 pages of OECD recommendations. In our view the breath and complexity of the proposals mean that there is a high risk of overreach and collateral damage i.e. a high risk that the proposals will affect genuine commercial transactions that are not the target of the OECD's recommendations. Overreach will create a particular problem if deductions are denied on interest cost necessarily incurred in funding New Zealand business operations.

The complexity of the proposals is such that they also risk creating real uncertainty for taxpayers. Legislative amendments to address hybrid mismatch arrangements should be drafted narrowly and as precisely as possible so that the potential for overreach and collateral damage to commercial arrangements is avoided or at least minimised as far as possible.

As Luedicke states:

> "Such countermeasures [anti-hybrid rules] should be drafted as narrowly and precisely as possible based on a proper consideration of situations which do indeed raise policy concerns. It is important to consider that any countermeasure is a deviation from the "normal" system of the tax law based on rules chosen by a sovereign legislator. These rules are generally independent of other states' laws. Countermeasures need to be drafted in a way which avoids unintended economic or juridical) double taxation. … They should not punish taxpayers for behaviour which is caused by uncoordinated or deficient legislation."[2]

There appears to be an underlying assumption that hybrid instruments are exclusively tax driven so that any overreach or collateral damage can be dismissed. We think this assumption is flawed.

Timeframe and process

A more considered approach will result in a better quality and sustainable outcome, without compromising New Zealand's ability to achieve appropriate reforms within OECD preferred timeframes. Indeed, the OECD anticipates that countries will need to move at a pace and scope commensurate with their existing tax systems and with legislative and government priorities.

In our view the Government would be better advised to take a targeted approach to addressing hybrid mismatch arrangements. By this we mean an approach whereby any amendments to New Zealand's domestic tax laws are focused specifically on the use of hybrid entities or instruments in New Zealand that the Government does not believe can be addressed by the existing law including the general anti-avoidance rule.

A more targeted approach would result in law reform that is more relevant to the New Zealand 'context'. It would also be able to take into account that New Zealand already has robust primary rules including the denial of foreign dividend exemptions for deductible dividends and a powerful and judicially supported general ant-avoidance rule.

A more considered approach would also ensure New Zealand does not become an early adopter or a leader in this context. We understand that Australia has yet to release draft legislation for consultation or introduce a Bill and is unlikely to do so until next year (which, given the Parliamentary process and the Board of Taxation's recommendation of an application date 6 months after enactment, would suggest a 2019 application date). As a significant portion of New Zealand's inbound investment is sourced from Australia, it would seem sensible for the Government to wait until Australia's legislation has been introduced. This would allow the New Zealand legislation to be aligned with Australia's rules where appropriate.

[2] Ibid, 310

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Part II

Part II of the Discussion Document poses twenty nine questions, almost all of which are open ended. For example:

- 5B "are there any issues with the proposed approach in applying the secondary rule to hybrid dividends?"
- 5D "will this approach to CFC inclusion give rise to any practical difficulties?"
- 5H "are there any issues with providing no exclusion for regulatory capital?"
- 6D "is it appropriate to depart from the OECD's recommendations in relation to CFC income as dual inclusion income?"
- 9A "are there any issues that may arise in relation to the implementation of Recommendation 7 (dual resident payers) in New Zealand?"

This approach effectively requires taxpayers to anticipate and suggest solutions to any issues arising from the proposals. In our view this analysis should be undertaken by Officials.

A more effective approach would be for the Government, first, to clearly articulate the policy rationale for, and the scope of, the project; secondly, to release more detailed targeted proposals; and, thirdly, to prepare, release and consult on draft legislation. Such an approach would allow the private sector to respond to specific proposals rather than to a set of broad, open-ended questions. It would also ensure that Officials have had the opportunity to turn their minds to the policy rationale for specific amendments, to the practical implications of the proposals in a specifically New Zealand context and to drafting rules that are comprehensible and fit for purpose.

We provide below some comments on Part II of the Discussion Document. In the time available and given the broad manner in which the questions in Part II are posed, our comments are necessarily of a high level only. Once Officials have undertaken further work on developing proposals that address the issues in a New Zealand context more specifically and have released draft legislation, we are likely to be in a better position to comment more fully. In the meantime the comments made below should be considered preliminary only.

Chapter 5: Hybrid financial instruments

Recommendation 2: changes to existing domestic rules

Expansion of section CW 9(2) (c)

We understand the rationale for expanding section CW 9(c) (2) to deny exemption for a dividend which gives rise to tax relief equivalent to a deduction in the payer jurisdiction.

Denial of imputation credits

It seems appropriate for the definition of "segment" to be changed so that any payment of a dividend on a share subject to a hybrid transfer is treated as a separate segment of foreign sourced income.

Recommendation 1: linking rules

We consider that the need for a payment deductible in New Zealand under a cross border financial arrangement to be taxed in the hands of a taxpayer of ordinary status within a reasonable period of time fails to fully recognise that hybrid mismatches are often temporary rather than permanent. Any denial of deduction should occur only when the hybrid mismatch has a permanent effect.

Differences in valuation of payments not relevant

We agree that the difference in valuation of payment is not relevant as a foreign currency loan will normally give rise to a foreign currency gain or loss in respect of the loan.

In respect of optional convertible notes in the New Zealand context we suggest that the issue has been settled.

New Zealand financial arrangement rules count foreign currency gains or losses as interest. It is proposed that only the interest component under a hybrid instrument be subject to denial of deduction. This means that any foreign currency gain or loss will need to be excluded. This will add to compliance costs and require changes to some accounting systems.

Timing differences

The Australian Board of Taxation Report has recommended a three year gap between deduction and inclusion of income and payments. Our preference is for the focus to be on permanent mismatches rather than on temporary timing mismatches between deduction and inclusion. This is particularly the case because chapter 11 proposes that withholding tax should continue to apply. This will create double taxation of the same income. It is inconsistent with New Zealand's approach to the taxation of equity income.

A three year approach, as suggested by the Board of Taxation, may be an acceptable compromise to ensure that shorter timing mismatches are not subject to complex rules. A commercial test, where the loan terms match expected cash-flows, should also be available.

We support the Board of Taxation's carry-forward proposal so double taxation does not occur. We also believe consideration should be given to the UK approach of reasonable, consequential adjustments (carry back adjustments).
There also needs to be the ability to allow for correction of treatments as countries' time frames for implementation of the hybrids recommendations will vary, with some countries unlikely to adopt any or very few of the proposals and others likely to defer adoption for some years.

Taxation under other countries' CFC rules

It is likely to be difficult for New Zealand corporates to establish that a payment is subject to tax in the hands of the payee's owner under a CFC regime. New Zealand entities are often at the 'bottom' of corporate structures and, in many cases, payments made by or to New Zealand corporates will be immaterial to the group's overall position. They will often be unfamiliar with the tax treatments prevailing in the jurisdictions in which other members of the group are located.

However, given the target is D/NI income, if a CFC regime overturns that result, the hybrid rules should not apply. In the absence of a CFC exclusion, the result of the hybrid rules applying would be an ND/T double taxation result.

We are comfortable that the existing onus on taxpayers would mean that only taxpayers who have appropriate systems or material amounts would be able to use this exclusion. The expected difficulty in complying should not prevent those who can comply from benefitting from a principled rule.

Proportion of purchase price treated as payment under a financial arrangement

There is no principled justification for this proposal.

Hybrid transfers

We agree that there should be rules to address share loans or share repos (where the transferor and transferee are both treated as the owner of a financial instrument) that give rise to a hybrid mismatch.

Substitute payment

We agree that, if a substitute payment gives rise to a hybrid mismatch, the hybrid rules should apply subject to any timing rules.

Regulatory capital

Further detailed consideration needs to be given to whether New Zealand should exclude regulatory capital from any hybrid rules it implements. The Australian Board of Taxation highlighted the complexities and interactions involved and recommended further work be undertaken on the issues.

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Applying the secondary rule to hybrid dividends

We understand the Government's reasoning for applying the secondary rule to hybrid dividends.

Timing mismatches

We understand the desirability of matching the Australian approach to removing any timing advantages should New Zealand not adopt the same deferral period. This will also depend on the carry back or forward treatments introduced.

Effect of CFC inclusion on application of Recommendation 1

We predict practical difficulties arising where multiple countries are involved with some having hybrid rules and others having no rules or limited rules. Taxpayers will have to bear significant compliance costs.

Taxation of FIF interests

We recommend that FIF interests are excluded from any hybrid rules. Although any rules may only affect FIFs with ownership between 25 and 40 percent (see our comments regarding structured arrangements), the exclusion of dividend income is in effect part of the income calculation. The FDR, cost and DRR methods are proxies for income from a share that in the classic sense is a dividend.

Transfer of assets: revenue account holders

We agree that revenue account holders should be exempt from the rules.

Transfer of assets: hybrid transfers

The recommendation to amend the income tax treatment of New Zealand residents who hold shares subject to a hybrid transfer appears to be a practical response given New Zealand's current rules.

Other exclusions

We consider it desirable that New Zealand gives an exemption to any hybrid rules to which a financial trader is a party. This would be consistent with the UK and Australian proposals.

Applying within New Zealand

We see no policy rationale for applying any hybrid rules to arrangements within New Zealand.

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Chapter 6: Disregarded hybrid payments

We are concerned at the uncertainty likely to arise in this area. As noted at paragraph 6.7 of the Discussion Document the question of whether an entity is a hybrid payer will not turn on a preordained list of entities and no characteristics in and of themselves would qualify an entity as a hybrid payer. An entity that is considered a hybrid payer in one scenario may not be a hybrid payer under a different scenario. In our view caution is required before such a broad-brush recommendation is implemented.

Applying carry forward loss rules to carry forward of disallowed deductions

We agree that denied deductions should be able to be carried forward. Applying the current carry forward loss rules to the carrying forward of disallowed deductions is less clearly justified. The effect of the denial is either to treat the deduction as not incurred at that point or as a matching rule with the future income. The principled result seems to be to consider whether there is any net income. As there is not, no taxation should arise.

Dual inclusion income

A simple dual inclusion income approach would be needed to avoid unnecessary complexity and excessive compliance costs.

Carry forward / reversal of defensive rule income

Given the potential for over-taxation in the absence of a carry-forward rule for the application of the defensive rule, we believe it is appropriate to depart from the OECD's recommendations. A reversal rule whereby the defensive rule in the payee country could be reversed (through an allowable deemed deduction) in a later year where there is excess dual inclusion income seems easier to apply than a limitation of the defensive rule.

CFC income as dual inclusion income

Excluding CFC income from dual inclusion income seems appropriate given the likely infrequency of situations in which inclusion is required and the likely complexity of rules to address the issues. However, we note the likely double taxation effect. The ability to exclude CFC income should therefore be considered (in the knowledge that not all taxpayers who might benefit would incur the costs of compliance).

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Chapter 7: Reverse hybrids

Recommendation 4

One of the difficulties with Recommendation 4 is that a taxpayer making the payment will require detailed knowledge of the tax treatment of the payment in the hands of the payee. This is likely to be more difficult for extended control groups (beyond parent-subsidiary relationships). In addition, to administer these rules, Inland Revenue will need to have a complete understanding of the tax treatment of each payment in each jurisdiction. This seems unlikely.

Recommendation 5.1: CFC rules

We do not believe it is in New Zealand's interest to amend its CFC rules. New Zealand's CFC rules are robust and already meet OECD's best practice. Furthermore, our CFC rules were amended in 2009 to reduce barriers faced by New Zealand companies and encourage businesses with international operations to remain in, establish or expand their offshore activities.

The current CFC rules are extremely complex and impose a compliance and administrative burden on taxpayers. Further amendments to the CFC regime, to impose New Zealand tax on income allocated to a New Zealand resident by a reverse hybrid, will increase the complexity of the rules and the compliance and administrative burden. For some CFCs, financial information may not be available. This could occur when the taxpayer does not control the CFC.

These proposals could inhibit the retention or establishment of New Zealand based multi-national businesses. We note that the Australian Board of Taxation's March 2016 report to the Australian Treasurer recommends that OECD Recommendation 5 not be implemented immediately but that it be left open to implement in the future if integrity concerns arise and after the merits have been given further analysis.

Reverse hybrid entities established in New Zealand

Foreign trusts

First, we do not believe New Zealand foreign trusts should be treated as reverse hybrid entities. Foreign income derived by foreign trusts is exempt, New Zealand foreign trusts are taxed on New Zealand sourced income only. New Zealand taxes trusts (including foreign trusts) as opaque entities. For example, where a foreign trust derives New Zealand source income, the trustee is taxable (not the beneficiaries or settlor). If income is allocated to beneficiaries, the tax liability is on the beneficiaries but that is equivalent to a deduction outside the scope of the hybrid proposals, as per the Discussion Document's own reference (at para 4.7) to the OECD report. If that were not the case, co-operatives would be reverse hybrids. For these reasons alone, foreign trusts should not be classified as reverse hybrid entities. The fact that New Zealand provides an exemption for the foreign sourced income of foreign trusts is not relevant. The OECD report is clear that the fact that a country provides tax exemptions does not create hybrid mismatches that should be subject to these rules.

In our view it is inappropriate for New Zealand to tax foreign sourced trustee income. The income has no connection with New Zealand apart from the existence of a trustee in New Zealand who has no beneficial interest in the income. New Zealand's current trust regime was established in 1988 and is based on the international model that taxes residents on their worldwide income and non-residents on local income derived from that country. Under this model, non-residents are deliberately not subject to New Zealand tax on their foreign sourced income. The Shewan Inquiry reviewed this outcome and concluded the current tax treatment was appropriate. Applying Recommendation 5.2 to tax trustee income, if it is not taxed to the settlor (assuming a settlor is alive and/or exists) or any other person is unprincipled and changes a fundamental aspect of New Zealand's tax policy settings. From a New Zealand perspective, there has been no erosion of the tax base.

New Zealand branches

It is not clear that New Zealand should implement a rule that would have the effect of taxing income, that under current New Zealand tax rules is not taxable, simply because it is treated by another jurisdiction as attributable to a New Zealand branch and not taxable in that jurisdiction.

As a small capital importing country New Zealand has to balance following the OECD's recommendation and being an attractive place for non-residents to invest.

The Discussion Document appears to fail to consider the recent amendments to the NRWT rules (narrowing of the onshore branch exemption) included in the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill. As a result of the proposed amendments interest income derived by a non-resident with a New Zealand branch will be subject to NRWT unless the money lent is used by the non-resident for the purposes of a business it carries on through its New Zealand branch. If interest income derived by a non-resident is made taxable because New Zealand implements the OECD recommendation to neutralise mismatches caused by differences in the allocation of income between the branch and head office, New Zealand's claim to tax increases to 28%. If that tax increase is passed back to a New Zealand borrower (via a gross-up clause), the New Zealand borrower will suffer an increased cost of funding.

The lack of discussion of the NRWT amendments surprises us. In considering whether to adopt the OECD hybrid recommendations, the Discussion Document should have considered the outcomes for all of the tax regimes including NRWT.

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Chapter 8: Deductible hybrid payments

Exemption for active income of foreign branch

If foreign branch losses are not able to be deducted against New Zealand income, there should be a matching active income exemption.

Alternatively, consideration could be given to including a provision that preserves New Zealand tax if a New Zealand corporation has deducted foreign branch losses from its worldwide income and then once it becomes profitable exchanges its branch assets for foreign corporation shares.

Chapter 9: Dual resident payers

Recommendation 7: Dual residents

In our view the Chapter 9 fails to take into account commercial realities. Paragraph 9.3 states: “However, given that dual residence status is in most cases deliberate rather than accidental, it should be possible for taxpayers to be aware of the possibility of double taxation, and by adopting simpler structures, avoid it”.

In our experience “dual residence status” is most often the inevitable result of companies operating cross border where New Zealand statute makes a company resident if either incorporated or managed or controlled from New Zealand. In a trans-Tasman context this inevitably gives rise to dual residence. If New Zealand wants to avoid dual residence of companies it should limit the breadth of our corporate residence test – not punish those who are dual resident as a result of it. As the law now stands a New Zealand incorporated company can unintentionally become a dual resident when New Zealand directors, who manage and control the company, emigrate.

Practical difficulties will arise in identifying dual inclusion income where income is recognised at a later point in time.

Excess amounts disallowed should be able to be carried forward to set off against dual inclusion income in another period.

DTA dual resident rule

Before implementing such a rule, the implications of treating a New Zealand entity as a non-resident need to be fully considered. The effect on New Zealand’s revenue base must be considered. The rule would mean that **all** foreign sourced income derived by a non-resident under a DTA tie-breaker test that breaks the residence to the other country would not be subject to New Zealand tax under New Zealand domestic law. Furthermore, non-resident passive income could be subject to a lower rate of New Zealand tax.

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Chapter 10: Imported mismatches

Recommendation 8: Imported mismatch rule

We consider that the imported mismatch rule will impose a significant compliance burden on New Zealand taxpayers (and also on Inland Revenue). As acknowledged at paragraph 10.5 the imported mismatch rule will be complex to apply and will require knowledge of the tax consequences of a wide range of transactions within a group. We strongly disagree that the necessary information will be readily available if a group is structured in a straightforward way and monitors the existence of hybrid mismatches intra-group transactions. Given that most of our major trading partners have not implemented these rules it is unlikely that groups will be monitoring the existence of hybrid mismatches on all intra group transactions.

The imported mismatch rule can apply where a New Zealand borrower makes a payment under a (vanilla) loan, and under another arrangement in the series there is a relevant mismatch which is not counteracted by foreign equivalent provisions.

New Zealand taxpayers will be expected to follow funding arrangements and work out that a mismatch arises in arrangements between third countries. Difficulties in tracing and apportionment are likely. The source and application of funds is not always clear. Taxpayers will need to keep abreast of any law changes in those foreign countries that may change the New Zealand tax treatment. To administer these rules Inland Revenue will need a complete understanding of the respective tax treatment for each entity in a wider chain of entities involved, including aspects that otherwise have no direct effects or consequences from a New Zealand revenue perspective. Based on the OECD recommendations, the imported mismatch rule contains design thresholds which will make the rule extremely difficult to comply with and administer.

Importantly, the imported mismatch rule will breach a fundamental tax policy design principle, namely that the policy is workable for taxpayers and compliance costs are kept to a minimum[3].

Further, the fact that this recommendation is being considered undermines the case for adopting the OECD recommendations. Part 1 concludes that global implementation will likely benefit New Zealand. Recommendation 8 assumes the hybrid rules have not been adopted.

CA ANZ strongly recommends that Recommendation 8 is not implemented until a majority of other OECD countries have implemented their own hybrid mismatch rules. If New Zealand implements the hybrid mismatch rule ahead of its trading partners, an unfair compliance burden will fall on New Zealand taxpayers.

[3] Recommendation 9 1(h)

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Chapter 11: Design principles, introduction and transitional rules

Design principles

At this early stage of proposal development we believe that what is likely to be required is a balance of principles-based drafting, which sets out the policy underpinning the rules, and more precise and prescriptive drafting for issues that require clear boundaries and the provision of certainty to taxpayers. In the absence of more definitive proposals, including draft legislation, it is however, difficult to form a view.

Date of introduction

In our view New Zealand should defer the introduction of anti-hybrid rules until the approach to be adopted in the majority of other OECD and G20 countries is much clearer. Australia and the United Kingdom have progressed further than other OECD / G20 countries but it is important to see how the United States, Canada, Singapore, Japan and other sources of inbound investment also respond. New Zealand should not get ahead of other countries and particularly Australia which we understand has introduced but not enacted legislation.

We note that the Board of Taxation in Australia has recommended that the rules should commence in Australia for payments made on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives the Royal assent. At a minimum New Zealand should not contemplate an effective date until after the Australian legislation has become effective.

Grand-parenting

Existing arrangements have been put in place on the basis of the current rules. Applying very complex new rules to existing arrangements seems unfair and likely to impose high compliance costs. On that basis we suggest arrangements existing at the date of introduction of the new rules in a Bill should be grand-parented. If existing arrangements are not grand-parented New Zealand taxpayers will have to bear the costs of unwinding or restructuring existing arrangements (break costs, advisor fees, foreign exchange adjustments) and the additional funding costs of replacing the arrangements.

We note that the Australian Board of Taxation has not recommended grand-parenting as a general rule but has suggested that, as the legislation is developed, there may be certain categories of arrangements that are identified as appropriate for grand-parenting. This approach seems to leave significant scope for uncertainty but may be fairer as it allows scope for appropriate grand-parenting.

Transitional rules

Given the extremely complex nature of the proposals, and the likelihood that the draft legislation could undergo significant change as it goes through Parliament, transitional rules should be introduced. Again the Australian Board of Taxation did not recommend transitional rules generally but noted that during the legislative design process "it may be identified that particular categories of arrangements require transitional rules" – again an approach that could lead to uncertainty but may be helpful from a fairness perspective.

De minimis rules

In our view de minimis rules can be useful if they minimise the compliance costs imposed on taxpayers. If, however, such rules require taxpayers to undertake complex calculations and analysis to determine whether they can be relied upon, they cease to be useful.

The inclusion of a de minimis rule is likely to be particularly important in the context of the imported mismatch rule, which requires taxpayers to be aware of the tax treatment of different entities and instruments in multiple jurisdictions.

Withholding tax

In our view imposing withholding tax while denying a deduction for a payment would be inequitable. Such an approach would increase the cost of capital if there is a gross up clause, which will generally be the case

Chapter 12: Key definitions

All definitions will need to be clear and unequivocal.

Structured arrangement

Paragraph 12.7 proposes to amend New Zealand legislation and include a definition of "structured arrangement". However, we note that paragraph 12.6, which is integral to the definition of "structured arrangement", will not be incorporated into New Zealand legislation. Paragraph 12.6 sets out the facts and circumstances which should be taken into account in determining whether or not an arrangement has been designed to produce a hybrid mismatch. On its own, paragraph 12.7 is capable of wide application to common investments. (See the FIF paragraphs at 5.41 which raise that possibility.)

We refer to Professor Luedicke's view quoted at page 4. The anti-hybrid rules should be drafted narrowly and precisely. The proposed definition at 12.7 is neither narrow nor precise.

We recommend that paragraph 12.6 be incorporated into New Zealand legislation.

We are happy to discuss our submissions with you. If you have any questions please contact Teri Welham, Stephen Rutherford or me.

Yours sincerely

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