Addressing hybrid mismatch arrangements
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Dear Sir/Madam

We appreciate the opportunity to comment on the Government discussion document *Addressing hybrid mismatch arrangements* released 6 September 2016.

Submissions

In addition to our initial submission comment in this paragraph, we set out below five other submission points which we believe the Commissioner should consider in the interest of providing clarity to a wide range of taxpayers.

1. *We have kept the submission points deliberately high level as one of our key overall submission points and concern is that a lot more detail around the design and outline of the legislative provisions is needed. Once provided, we will be in a position to give proper consideration to the design of the wide ranging and multi faceted proposals which impact many areas of the tax legislation.*
2. *New Zealand should not be one of the first wave of "early adopters" and should not implement the hybrid mismatch arrangement rules prior to a reasonable proportion of OECD countries enacting the rules.*

It is our view that, at a minimum, the timing of implementation should be coordinated with other OECD jurisdictions to ensure New Zealand is not in the first wave and, if necessary, deferred until the majority of countries with a New Zealand taxation connection, such as those with capital funding into New Zealand, have implemented the anti-hybrid rules. We consider there to be little advantage for New Zealand being an early adopter and effectively acting to close down tax mismatches that are usually caused by the specific tax rules in other countries rather than in New Zealand.

The discussion document references rules to come into effect in the UK and Australia. Our understanding is that the implementation of such rules in Australia is likely to be behind the timetable referenced in the discussion document, and draft legislation has not yet been worked on in any detail. We also consider it likely that the legislation actually enacted in a number of countries will be materially watered down or countries will have other features in their overall tax regimes so that they remain internationally attractive to multinational groups. We consider it very prudent for New Zealand to watch and observe and ensure that the tax rules that we enact in New Zealand do not end up disadvantaging New Zealand from an overall international competitive perspective compared to the tax rules that actually end up being implemented in our major trading partners.

The successful implementation of the OECD recommendations regarding hybrid mismatch arrangements released in late 2015 are hinged on the precondition that most countries will adopt the rules. The United States has indicated they will not adopt the OECD recommendations and despite the "expectation that countries that are part of the consensus will act", there is no guarantee whether, or confirmation when, these other countries will take real action and introduce significant law changes.

Advancing with the implementation of these rules, based only on the presumption that the rest of the world will match these actions and in a pure and consistent way based on the OECD recommendations, exposes New Zealand taxpayers to substantially increased costs of tax compliance and administration without the guarantee of reciprocity made in counterparty jurisdictions. New Zealand should not place itself in a position to be the "world tax police", left responsible for monitoring cross-border transactions to ensure that the correct amount of tax is collected globally. The tax base of New Zealand may not be significantly benefited where taxpayers restructure such arrangements prior to the introduction of these rules – for example, replacing interest deductions arising from a hybrid financial instrument with interest deductions arising on a "vanilla" debt instrument. Rather, the focus needs to be refined so that consideration is also given to the overall competiveness of New Zealand's tax system in light of these proposals and accordingly the long term impact on the New Zealand economy.

We request that the Government and the Commissioner consider a more appropriate delayed timeframe for implementing any of these rules in New Zealand, with particular reference to the timing and implementation of the rules in other jurisdictions.

This is particularly true for the proposed imported mismatch rule. To the extent that such rules are determined to be required in New Zealand (which we doubt is really needed weighing up all the factors), at a minimum, New Zealand should phase in this complex tax burden following the introduction of the rules by our key trading partners. As noted by the Board of Taxation in the review of implementation of the imported mismatch rule in Australia, such rules would give rise to "considerable compliance challenges", would be "difficult to administer", and would place "unfair compliance burden on [Australian] entities". In our view New Zealand should not implement the imported mismatch rule.

3. *Targeted domestic tax rules to address specific concerns, such as the foreign dividend exemption provision, would be a more pragmatic option in the short term given the relative urgency expressed in the discussion document for the introduction of anti-hybrid rules*

The complexity of the proposed rules, as discussed further below and discussed with Inland Revenue Policy officials in several different forums over the last month or more, is indicative of how challenging the underlying objective ultimately is. We understand the political drivers behind the proposed changes (and we consider the political pressure to be seen to be acting at the head of the pack is dangerous and slightly naïve given New Zealand's economic position as needing foreign investment to continue to grow). Therefore, we urge that the detailed design of these rules not be rushed in New Zealand so that there is sufficient time to work through the intricacies and observe how a number of other countries actually implement the rules, to assess how they interact with the various regimes in the existing legislation and to allow for undue complexities to be reduced as much as possible.

Targeted and specific rules can more easily be isolated and examined so that each knock-on effect can be thoroughly, and responsibly, explored. The discussion document concedes in section 3.17 that "the New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown". Additionally, the same section suggests that the tax revenue at stake in relation to funding arrangements comparable to the *Alesco* arrangement is approximately $300 million. However, the *Alesco* case involved no loss of revenue, because if the purchase had been funded by ordinary interest bearing debt (rather than the hybrid, Optional Convertible Note) the same interest deductions would have been claimed by Alesco New Zealand. We urge that the overall benefit to New Zealand be carefully modelled to maintain the integrity of the New Zealand tax system. Further, these benefits should be weighed up against the cost of new rules to substantiate their introduction.

Further, we note that the majority of hybrid financing arrangements such as *Alesco* are a feature of the past given the dramatically changed tax risk environment in New Zealand in recent years. This needs to be factored in to ensure the complexity of the rules far outweighs the practical relevance in New Zealand going forward.

We request that the Commissioner delay the introduction of wide sweeping rules and instead prioritise certainty above all else. Alternatively, while awaiting the introduction of hybrid rules in overseas jurisdictions, targeted New Zealand tax rules could be implemented that capture a specific hybrid structure or instrument that has been identified by Inland Revenue as particularly concerning in a New Zealand context (such as the extension of the carve out to the foreign dividend exemption in CW 9 mentioned in the paper).

4. *The current level of complexity of the proposed rules means they will be hugely difficult for taxpayers to interpret and comply with in practice*

The theoretical benefit of the proposed rules is significantly impeded by their complexity. Taxpayers will have to go to extraordinary efforts and ongoing cost, not only to understand how the new rules will apply to their business, but also to acquire a detailed understanding of the tax law in each counterparty jurisdiction before the new rules can be correctly applied. We are concerned that the complex nature of the proposed rules will lead to increased compliance costs for both taxpayers and tax administrators.

For example, with regard to hybrid financial instruments, the rules require taxpayers to understand in the counterparty jurisdiction the ordinary tax treatment of a payment; whether a deduction would be denied or participation exemption switched off; and anticipate the future tax treatment of the payment to determine whether the mismatch is purely a timing difference. This is only one simplified timeline of events. There will inevitably be unforeseen complexities that disrupt this logical sequence. One example of an unforeseen complexity is where the New Zealand taxpayer denies a deduction in New Zealand after identifying a mismatch in the counterparty jurisdiction; at a later point in time the tax authority in the counterparty jurisdiction disputes the tax treatment of this income; the income is subsequently deemed to be taxable. The New Zealand taxpayer that has complied with the rules is left disadvantaged unless the income tax return that corresponds to the denied deduction is reopened and corrected.

The proposed ability to carry forward disallowed deductions to offset against "dual inclusion income" (which in itself is a complex concept and will need careful drafting to be understandable) in future years is intended to benefit taxpayers by preventing double taxation but the discussion document does not consider how this will be achieved practically. It assumes New Zealand entities will have the ability and capacity to track disallowed deductions in New Zealand going forward together with the corresponding receipt in the counterparty jurisdiction. We support the fairness that this proposal is seeking to achieve, however we are concerned that the difficulty and increased compliance burden associated with tracking the treatment of two amounts in two different jurisdictions will ultimately result in double taxation.

We consider that making the hybrid mismatch rules sufficiently difficult so that businesses are encouraged to use simpler structures, which do not require the rules to be applied, is not an appropriate justification for their complexity. There are valid commercial reasons for establishing such structures and these should not need to be discarded in exchange for the possibility of eliminating mismatches. Given the complexity of the issue, the rules should not be designed solely with taxation outcomes in mind.

We request that the Commissioner make every effort to ensure future communication of the proposed rules is presented in a way that the practical impact can be better understood by taxpayers. Supporting guidance in a second round of consultation (before draft legislation going into a Tax Bill) in the form of detailed commentary and design of the provisions needed should be provided to assist taxpayers to navigate the proposed rules in a way that is not dependent on a high level of tax technical knowledge. The rules should be effective at disqualifying inappropriate advantages but not at the expense of the integrity of New Zealand's tax system or New Zealand's investment.

5. *The implied ability of New Zealand taxpayers to access sufficient information to comply with the proposed rules is inconsistent with commercial and practical reality and does not contemplate the barriers that New Zealand taxpayers are likely to encounter in practice*

The discussion document comments in relation to accessing information that "[…] the imposition of such a rule by New Zealand should not involve significant additional costs. This may require the New Zealand members of the group to have access to information held within the group but outside New Zealand. This should not be problematic, in a control group context."

We strongly disagree with the assumption that a New Zealand member of a control group will be able to easily access information and we are concerned that otherwise compliant New Zealand taxpayers will be unable to proffer sufficient information to comply with the proposed rules. Often, New Zealand corporates are at the "bottom of the chain" and are materially insignificant relative to other members of wider corporate groups. In this inbound context, requests for information from New Zealand are unlikely to be prioritised by global tax managers or executive groups. It will be particularly difficult to communicate the sudden need for certain information from counterparties in jurisdictions that do not have equivalent hybrid rules in place.

We expect that this problem will only be exacerbated outside of a wholly owned group scenario. Joint ventures will also be classified as under common control under proposals (i.e. a 50% test) and is an example of a situation where accessing information will not be a straight forward exercise. Others can be seen in the proposed CFC and FIF changes, which apply to "related entities", i.e. a 25% test.

From a practitioner perspective, lack of available information is also a concern. The proposed rules as they stand assume ease of access to detailed information, which may not always be possible, particularly in other jurisdictions that have tighter disclosure restrictions and generally less information transparency. In providing New Zealand tax advice, practitioners would be required to understand how counterparty jurisdictions throughout the chain treat the concerned payment and supporting information will also be required to substantiate advice provided. In practice this type of information is often legally privileged and therefore inaccessible without the risk of losing such privilege. We consider the expectations that the proposed rules will put on New Zealand practitioners to be contradictory to what has been established as good practice; New Zealand tax advice should be based on New Zealand tax legislation.

We request the Commissioner clarify what extra information will be required to support positions taken when filing a New Zealand income tax return and address how such information will be collected (e.g. through the Exchange of Information Agreement), particularly where rules prohibit its disclosure.

6. *Supplementary guidance and detail required before the full impact of each distinct rule can be adequately contemplated and to facilitate comprehensive discussion*

The complexity of the rules and the sweeping application that they are intended to have justifies the need for an in-depth analysis to determine all resulting implications. We do not consider the current guidance, nor the timeframe provided, sufficient to allow complete comments to be provided on each of the upwards of 25 submission points. There are a number of issues that have been left open by the document with an ask for taxpayers and practitioners to comment on and we are concerned that each of these will not be given the careful consideration that they require. We consider Inland Revenue needs to do a lot more thinking on the design of the rules and key aspects of the proposed legislative rules and then ask for consultation and feedback again.

The discussion document also makes certain assumptions that should be considered further. For example, in considering dual resident entities, the paper states that dual resident entities arise as a result of tax planning. In our experience, this is generally not the case, and instead is more likely to arise through innocuous actions, where taxpayers have inadvertently relaxed governance procedures, resulting in dual resident status. Given the practical reality of such arrangements, the proposal to remove the Place of Effective Management test will likely put pressure on competent authorities, requiring significant additional resources for this work to be undertaken and significant time delays. Our view would be to retain the current tie breaker test.

Additionally, the discussion document does not appropriately address the interaction of the proposed hybrid rules with New Zealand's existing tax rules. The impact on New Zealand's withholding tax, thin capitalisation and transfer pricing regimes is noted only at a high level. The implications for these proposed changes should be further outlined for taxpayers' consideration, and in particular, should ensure that a consistent approach is taken for the hybrid rules as are currently in our tax rules. For example, the tax outcome of the hybrid proposals for a hybrid instrument seek to "disallow deductions" claimed, effectively re-characterising the instrument as equity for tax purposes (similar to a section FA 2 debenture). However, it is proposed that interest withholding tax would still be payable on the disallowed interest. We have major concerns with this. This can be contrasted with the thin capitalisation rules that acknowledge the interest deductions claimed but seek to deem interest income to arise to the New Zealand taxpayer where the safe harbour thresholds are exceeded, which seems much more rationale.

In relation to the transfer pricing implications of the proposed rules, other than the high level comments provided in paragraphs 11.5 and 11.6, we are uncertain how the rules would operate where the transfer pricing methodology used in the counterparty jurisdiction differs from that used in New Zealand. In practice, we are aware that interest rate pricing often varies between jurisdictions with different levels of "safe-harbours" and expectations with respect to the level of interest rate pricing analysis undertaken. Although there is no mismatch with regard to the treatment, clarification is required in relation to how the difference in the two "arms-length" amounts should be treated (i.e. is the New Zealand taxpayer required to include an additional income top-up to account for this difference?).

The Commissioner should provide additional guidance to support the proposed rules, once they have been more fully developed, and which considers the resulting implications of the fundamental shifts in practice that will need to take place to facilitate compliance with the rules.

General

We trust these high level comments are useful and we look forward to providing more detailed comments on a further round of consultation once more thinking and design and high level drafting of the different points are worked on by Inland Revenue and circulated for further comment and consideration.

Yours sincerely

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