

Budget Sensitive

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

Cabinet Economic Growth and Infrastructure Committee

FOREIGN HYBRID ENTITY DOUBLE DEDUCTIONS AND BEPS REFORMS

Proposal

1. This paper seeks Cabinet agreement to tax law changes to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships, to reduce their tax liabilities in New Zealand. In addition, this paper seeks Cabinet's approval for the proposals of three BEPS discussion documents to be progressed, subject to modification in consultation.

Executive summary

2. In September 2016, the Government released the discussion document *Addressing hybrid mismatch arrangements* [CAB-16-Min-0442]. This was followed by the release of two further discussion documents for public consultation in March 2017; *BEPS – transfer pricing and permanent establishment avoidance*, and *BEPS - strengthening our interest limitation rules* [CAB-17-MIN-0041]. These three documents are a substantial part of the Government's ongoing response to the OECD's project to address base erosion and profit shifting (BEPS). BEPS is a term that describes the various international tax planning techniques that some multinational businesses use to minimise their tax liabilities.

3. The *Addressing hybrid mismatch arrangements* discussion document proposed a comprehensive response to hybrid mismatches, including the use of double deductions by hybrid entities. Officials are currently consulting with the private sector on specific design issues relating to the proposals in the discussion document.

4. Before then, it is important to confirm that the Government is willing to act on the most prevalent hybrid structure involving outbound investment by New Zealand-based groups by restricting the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships (ALPs), to reduce their tax liabilities in New Zealand.

5. This paper also seeks Cabinet's approval for the other BEPS reforms proposed in the September 2016 and March 2017 discussion documents to be progressed, subject to modification in consultation, for implementation from 1 July 2018. When combined with the decision on foreign hybrid entity double deductions, this will result in an adjustment to the revenue forecasts of \$100 million per year from 2019/20 (with \$50 million forecast in the preceding year). Given this is a conservative estimate, we note there is an accompanying positive fiscal risk that the revenue may be higher than estimated.

6. We currently anticipate that final policy recommendations on these BEPS reforms will be considered by Cabinet later this year.

Background

BEPS

7. The New Zealand Government's ongoing 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, which was finalised in October 2015. 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.

8. Part of the OECD/G20 BEPS Action Plan is *Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements* (the OECD recommendations), under which the OECD has designed a set of hybrid mismatch rules for countries to incorporate into their own tax systems. While it is not mandatory to adopt the OECD recommendations, OECD and G20 countries have agreed a general tax policy direction in respect of Action 2. This means that they are expected to converge over time in their treatment of hybrid mismatch arrangements following the agreed common approaches.

9. The OECD has also recommended actions on *limiting base erosion involving interest deductions and other financial payments* (Action 4), *preventing the artificial avoidance of permanent establishment status* (Action 7) and *aligning transfer pricing outcomes with value creation* (Actions 8-10). The Government's March 2017 discussion documents outline a package of proposed law changes intended to address the OECD's concerns and recommendations in these areas, although the specific proposals are tailored for the New Zealand environment and so differ in some respects from the OECD's recommendations.

Hybrid mismatch arrangements

10. Hybrid mismatch arrangements arise when countries classify transactions and entities differently from each other under their domestic laws. For example, fixed rate shares may be treated as debt in one country and shares in another. This is inevitable. However, differences in classification provide multinational groups with opportunities to arbitrage between tax systems in two or more jurisdictions to create tax advantages. The result of hybrid mismatch arrangements is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates.

11. The Government's discussion document *Addressing Hybrid Mismatch Arrangements* proposed that New Zealand adopt the OECD recommendations by enacting a specific set of rules that remove the tax advantages of hybrid mismatch arrangements. The proposals apply mainly to related parties of multinational groups and planned arrangements. The expected outcome of having hybrid mismatch rules 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.

12. The global response on adopting the OECD recommendations on hybrid mismatch arrangements is as follows:

- a. The United Kingdom enacted rules earlier this year to counter hybrid mismatch arrangements (effective 1 January 2017).
- b. The EU has released a binding directive which requires EU members to introduce hybrid rules (effective 1 January 2020).

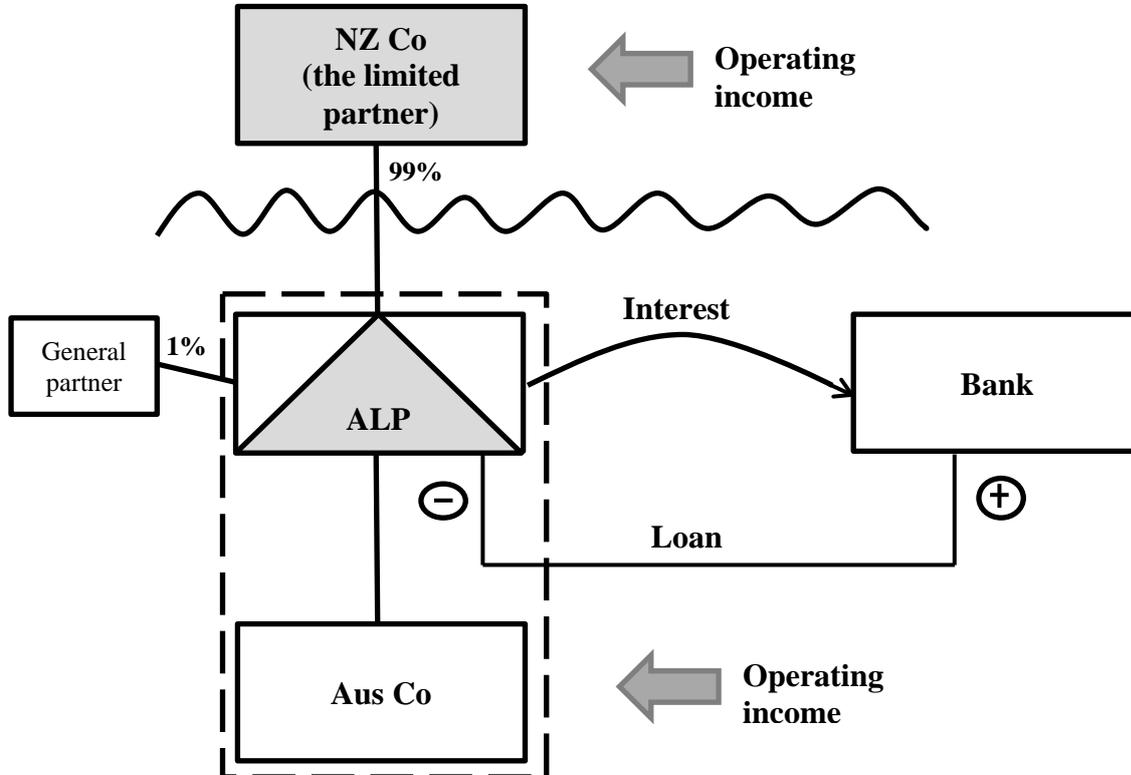
- c. Australia is committed to introducing hybrid rules (effective 1 January 2018 or 6 months after enactment).

Foreign hybrid entity double deductions

13. A type of hybrid mismatch featured in the OECD recommendations and featured in the *Addressing hybrid mismatch arrangements* discussion document is the double deduction mismatch, whereby a multinational group claims a tax deduction in two different jurisdictions for what is in substance one item of expenditure. This is most commonly achieved through the use of a hybrid entity – an entity that is treated for tax purposes as transparent (its income and expenditure is attributed to its owners) in the jurisdiction of its parent and opaque (it is taxed as a separate entity on its income and expenditure) in the jurisdiction it was established in. If that hybrid entity makes a loss it can be grouped against the profits of a related party in its establishment jurisdiction. Additionally, the hybrid entity's parent is attributed the losses of the hybrid entity under the parent jurisdiction's laws which can then be offset against its own profits. Each of these entity characterisations is valid when viewed in isolation, but in combination the hybrid entity allows the group to reduce its taxable income in two countries where there is only one economic loss.

14. This double deduction effect can be achieved through the use of an Australian Limited Partnership (ALP), which is a type of hybrid entity that can be established in Australia with a New Zealand company as the 99% parent/limited partner. The diagram below sets out this structure and assumes that the ALP borrows money from a third party bank (and pays interest on that loan) to help fund the wider group.

Figure 1 – ALP double deductions structure



15. The ALP is treated akin to a company in Australia, such that its deductions resulting from its interest payments can be grouped with the operating income of Aus Co to reduce tax payable in Australia. However, the ALP is treated as a partnership in New Zealand, so (99%

of) its deductions are attributed to NZ Co (the limited partner) and can be offset against New Zealand operating income. In this example, the expenditure of the ALP, and its ability to claim deductions, is uncontentious – it is interest payable at an arm’s length rate to a bank. Nevertheless, the tax revenue collected on two sources of operating income in two countries is reduced by using the ALP as the paying entity.

16. This paper seeks Cabinet agreement to introduce tax law changes to restrict the ability of a New Zealand business to use double deductions of foreign hybrid entities, such as ALPs, to reduce its New Zealand tax liability. This restriction may be limited, so it applies only to the extent that the double deductions are used to reduce the foreign tax liability of a related party.

17. Alongside rules to achieve this effect, an option being considered to reduce compliance costs is to develop an elective regime whereby the New Zealand parent of a foreign hybrid entity could elect to treat that entity as opaque in order to match the foreign jurisdiction treatment. This may achieve a slightly harsher outcome to the hybrid rule proposal, with reduced compliance costs. The purpose of such a rule would be to allow taxpayers a path to removing the tax advantage of their foreign hybrid entities while avoiding the scope of the proposed hybrid mismatch rules which carry a higher degree of complexity.

18. Final policy and design proposals on how the rule countering double deductions would be given effect, along with the remaining parts of the hybrid mismatch arrangements project, will be considered by Cabinet later this year. We currently anticipate this paper will be contemporaneous with a paper detailing the response to the other BEPS proposals mentioned below.

Other BEPS initiatives

19. The *BEPS – transfer pricing and permanent establishment avoidance* discussion document consults on proposals to counter permanent establishment avoidance, strengthen our transfer pricing rules, and help Inland Revenue deal with uncooperative multinationals. These proposals are aimed at large multinationals that are able to report low taxable profits in New Zealand despite significant economic activity here. The main proposals are:

- An anti-avoidance rule that will prevent multinationals from structuring their operations to avoid having a permanent establishment (a taxable presence) in New Zealand where one exists in substance.
- Stronger “source rules” so New Zealand has a greater ability to tax New Zealand-sourced income.
- Stronger transfer pricing rules which will adjust related party transactions if they don’t align with the actual substance of the multinational’s economic activities and shift the burden of proof onto the taxpayer (rather than Inland Revenue) for proving that their related party dealings are consistent with those that would be agreed by third parties operating at arms-length.
- A range of administrative measures that will strengthen Inland Revenue’s powers to deal with large multinationals (with at least EUR €750m of global revenues) that do not co-operate with a tax investigation.

20. Many of these proposals are based on similar tax reforms that Australia has introduced in recent years.

21. The *BEPS – strengthening our interest limitation rules* discussion document consults on proposed law changes that will limit the ability of multinationals to use interest payments to shift their New Zealand profits offshore. The main proposals are:

- A proposal to limit high-priced related party debt by introducing an interest rate cap. The proposed cap would base the allowable interest rate on the market interest rates that the particular multinational group would actually use when borrowing from a third party such as a bank. The cap would be based on the credit rating of the multinational group as a whole, rather than their New Zealand subsidiary.
- A proposal to tighten our existing thin capitalisation rules which limit debt as a percentage of total assets. The proposed rule would remove assets funded by non-debt liabilities from the measure of a firm's total assets. Examples of non-debt liabilities are trade credits, provisions and out-of-the-money derivatives. This change would bring New Zealand's rules more in line with other countries with thin capitalisation rules, including Australia.

Consultation

22. Inland Revenue and Treasury officials have discussed the foreign hybrid entity double deductions issue with interested private sector groups as part of ongoing consultation workshops on the wider hybrids project. Officials have also been in contact with the Australian Tax Office, the Australian Treasury, and the OECD secretariat in relation to this particular issue and the wider project.

23. In relation to the two March discussions documents, Inland Revenue has also consulted with the Treasury, the Ministry of Foreign Affairs and Trade and the Ministry of Business, Innovation and Employment. Officials have also been in contact the Australian Treasury and the Australian Taxation Office. Officials have started to meet with key stakeholders to discuss these proposals but submissions are not due until 18 April.

Financial implications

24. The proposed rule on foreign hybrid entity losses derived from the *Addressing hybrid mismatch arrangements discussion document* is estimated to increase tax revenue by \$50 million per annum once fully implemented. In the first year of application 2018/19, approximately half (\$25 million) of that estimated revenue will be captured.

25. That rule may influence taxpayers to restructure their arrangements so that they fall out of the scope of the rule. This should not alter the estimated revenue effect. Further, specific design issues relating to the proposed rule (such as the opaque election to ease compliance costs) should not affect the estimated revenue.

26. A total of \$140 million in additional BEPS revenues was estimated at the time the March discussion documents were released - assuming all of the proposals are implemented.

27. We seek Cabinet’s approval for the BEPS reforms to be progressed, subject to modification in consultation, for implementation from 1 July 2018. When combined with the decision on foreign hybrid entity double deductions, this will result in an adjustment to the revenue forecasts of \$100 million per year from 2019/20 (with \$50 million forecast in the preceding year). Given this is a conservative estimate, we note there is an accompanying positive fiscal risk that the revenue may be higher than estimated.

28. These estimates assume that the Government will introduce a BEPS taxation bill following the general election which includes the proposed foreign hybrid entity rule and other proposed BEPS measures and that the bill is enacted as legislation and is in force by 1 July 2018.

\$ million – increase / (decrease)							
Vote Revenue	2016 /17	2017 /18	2018 /19	2019 /20	2020 /21	2021 /22	2022/23 and out years
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

Human rights

29. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative implications

30. Primary legislation would be required to implement the proposals in this paper. At this stage, it is feasible for legislation to be introduced to Parliament that will encompass all the BEPS measures (including the hybrids mismatch arrangements project) in an omnibus taxation bill following the September general election.

Regulatory impact analysis

31. The Regulatory Impact Analysis Team at Treasury has advised that Inland Revenue is not required to prepare a Regulatory Impact Statement (RIS) at this stage of the policy process. The merits of the “in principle” decisions being taken at this stage can be made based on analysis already provided in the public consultation papers released last year (on hybrids) and in March (for the balance of the BEPS proposals). A RIS will be provided when Cabinet is asked to make final policy decisions on these measures.

Publicity

32. The offices of the Minister of Finance and the Minister of Revenue will arrange for the announcement of this decision if necessary, whether as part of Budget 2017 or otherwise.

Risks

33. There are risks associated with including the revenue from these changes in the Budget documents. Particularly in respect of the issues covered by the March discussion documents, the Government could be accused of making decisions before the consultation period has closed, effectively circumventing the generic tax policy process. Equally, the private sector may see the relatively conservative estimate of \$50m for these changes as an indication that the Government does not intend to implement the full suite of changes being consulted on.

34. In any event, we consider risks can be mitigated through clear communication of the process by which the estimates are included in the Budget process.

Recommendations

35. We recommend that you:

1. **Agree** to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities, particularly Australian Limited Partnerships (ALPs), to reduce their tax liabilities in New Zealand;
2. **Note** that the reforms proposed in the three BEPS discussion documents *Addressing Hybrid Mismatch Arrangements*, *BEPS – transfer pricing and permanent establishment avoidance* and *BEPS – strengthening our interest limitation rules* will be progressed, subject to modification in consultation, for implementation from 1 July 2018;
3. **Note** that as a result of agreeing to the foreign hybrid entity double deductions measure and progressing the hybrid mismatch arrangements project and the other BEPS proposals, the Budget 2017 revenue forecasts will adjusted as follows:

\$ million – increase / (decrease)							
Vote Revenue	2016 /17	2017 /18	2018 /19	2019 /20	2020 /21	2021 /22	2022/23 and out years
Foreign hybrid entity double deductions	0	0	25	50	50	50	50
Other BEPS measures	0	0	25	50	50	50	50
Total revenue effect	0	0	50	100	100	100	100

4. **Note** that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later this year.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

Hon Judith Collins
Minister of Revenue