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MINISTERIAL SERVICES UNIT

Tax policy report: BEPS - Recommendations on addressing hybrid mismatch arrangements

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|------------------------|---------------|-------------------|--------------------------|
| Date: | 22 June 2017 | Priority: | Medium |
| Security level: | In Confidence | Report no: | T2017/1604 IR2017/353 |

Action sought

| | Action sought | Deadline |
|---------------------|---|--------------|
| Minister of Finance | Agree to the recommendations in this report | 29 June 2017 |
| Minister of Revenue | Agree to the recommendations in this report | 29 June 2017 |

Contact for telephone discussion (if required)

| Name | Position | Telephone |
|---------------|---------------------------------|---|
| Steve Mack | Principal Advisor, The Treasury | Withheld under section 9(2)(a) of the Official Information Act 1982 |
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22 June 2017

Minister of Finance
Minister of Revenue

BEPS - Recommendations on addressing hybrid mismatch arrangements

Executive summary

1. This report seeks your:
 - agreement to detailed proposals for reforming the taxation of hybrid and branch mismatch arrangements, which implement in a New Zealand context Action 2 of the OECD Base Erosion and Profit Shifting (“BEPS”) programme (“hybrid proposals”); and
 - approval to prepare a paper requesting Cabinet’s agreement to include the hybrid proposals in a BEPS tax bill.

Development of recommendations to date

2. On 6 September 2016, the Government released a discussion document seeking feedback on proposals to address hybrid mismatch arrangements (T2016/1319 IR2016/342 refers). Broadly speaking, these are cross-border arrangements where the application of different countries’ tax rules results in either temporary or permanent non-taxation of income. Action 2 of the OECD BEPS Action Plan consists of recommendations for countries to address these arrangements. The discussion document proposals are closely modelled on the OECD recommendations as set out in its Final Report “Neutralising the Effects of Hybrid Mismatch Arrangements”.

3. On 9 March we reported to you on submissions in response to this document, and sought your approval to undertake further consultation (T2017/406 IR2017/133 refers). We also sought your approval for that further consultation to include consultation on branch mismatches, which are closely related to hybrid mismatches and in relation to which the OECD has developed a report (the “Branch Report”) with recommendations closely based on the hybrid mismatch recommendations. The draft branch report was published in August 2016 and the final branch report is expected to be available shortly.

4. We have now completed the further consultation. We have engaged in approximately a dozen workshops (with Corporate Taxpayers Group and Chartered Accountants Australia New Zealand) and attended various other meetings with private sector submitters (including

the New Zealand Bankers' Association). The consultation process was useful and we have made a number of changes to the proposals in the discussion document to take into account the concerns of submitters.

5. In particular, we have given careful consideration to the position of New Zealand businesses with foreign branches, to ensure that the proposed hybrid rules do not deny these businesses the ability to use any foreign branch losses in New Zealand except where there is a high likelihood of double non-taxation.

6. We have also consulted on the hybrid rules with counterparts in Australia and the United Kingdom, as well as the OECD secretariat, to ensure that the rules we propose work as intended, and do not give rise to inadvertent double taxation or non-taxation. Our proposals are very similar to Australia's hybrid proposals. We note in this report any significant points on which we are aware of a difference.

Budget 2017 decision on foreign hybrid entity double deductions

7. As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand (CAB-17-MIN-0164 refers). This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions. It is intended to come into force as part of the general hybrid rules dealt with in this report. Nothing in this report is inconsistent with that decision.

Format of this report

8. This report first provides a summary of the hybrids issue, the OECD solution, and officials' recommendation that New Zealand should implement that solution. The most significant issues arising from the recommendations of this report are separately commented on starting at paragraph 23.

9. The main body of the report goes through the OECD recommendations in numerical order. It discusses the general principles of each recommendation (or recommendations where they can logically be grouped) and then runs through a series of more detailed decisions that are consequential to the relevant principle. We consider these details will be important in creating a package that effectively counteracts the tax advantages of hybrid arrangements. There are some technical issues that we consider would still benefit from more consideration by officials before final decision are made. We have highlighted these areas both in the recommendations and in the body of the report.

10. We have included two appendices which are respectively a tabulated overview of the OECD recommendations and a glossary of some of the technical terms of this report.

Policy proposals

The issue: hybrid mismatches

11. The objective of the OECD hybrid rules is to prevent double non-taxation which arises because countries tax entities or arrangements in different ways. Broadly speaking, this double non-taxation can arise because:

- A payment is deductible to the payer in one country but not taxable to the payee in another country, if the reason for the mismatch is a conflict in tax rules. For example:
 - The tax rules applying to a corporate payee may treat the payment as a dividend on a share (which in many countries is exempt if the payer is a foreign company related to the payee), even though the tax rules applying to the payer in its home country treat it as interest on a loan. This is a hybrid financial instrument mismatch, and is dealt with in OECD recommendations 1 and 2;
 - The tax rules applying to the payee may treat the payer and the payee as a single taxable entity. An example of this is where a New Zealand unlimited liability company makes a deductible payment to its 100% US parent company. Under US tax rules, the New Zealand company can be treated as a branch of the US company, and therefore payments by the New Zealand company are disregarded for US tax purposes and so are not taxable. In this case the New Zealand company is a hybrid entity and the mismatch is dealt with by OECD recommendation 3; or
- A single payment is deducted against different income in two countries. An example is where a company with a tax loss is treated as tax resident both by New Zealand and another country. Suppose that the company has a profitable sister company resident in New Zealand, and another profitable sister company in the other country. If the loss can be grouped against the income of the sister company in both New Zealand and the other country, then the loss has been used twice, which means the group has been taxed on less than its full amount of net income. This is a dual resident company mismatch, and it would be dealt with by OECD recommendation 7.

12. Double non-taxation of this kind is difficult to deal with, because it arises even though both countries' tax rules are being complied with. However, it clearly reduces fairness, causes harmful distortions in investment patterns, and results in an unintended reduction in aggregate tax revenues.

The OECD Action 2 response

13. It is not feasible for all countries to have identical tax rules. Accordingly the only way to avoid double non-taxation of the kind referred to above is for countries to take a "tax without borders" approach by adopting, for cross border arrangements, tax rules which take into account in some way the tax rules of the other country involved. The OECD recommends two kinds of rules. The first kind are rules to reduce the likelihood of such mismatches arising. The second are "linking rules", which apply only to arrangements

between related parties (25% or more commonly owned) or structured arrangements (generally, arrangements between non-associated parties which intentionally exploit such mismatches). These linking rules apply to situations when there is a mismatch which has not been prevented by any other domestic rules, and provide for a primary and defensive response to the mismatch. This is explained further below.

14. The OECD hybrid recommendations are as follows:

- recommendation 1 deals with D/NI (deduction/no inclusion) payments under hybrid financial instruments which are either structured or between related parties;
- recommendation 2 deals with deductible dividends, which can also produce a D/NI outcome;
- recommendation 3 deals with D/NI payments by a branch or a hybrid payer entity to a person in the same control group (50% or commonly owned). A hybrid entity is treated as a separate person under its own tax rules, but disregarded/transparent under the rules of the payee country;
- recommendation 4 deals with deductible payments to a reverse hybrid in an arrangement which is either structured or between members of a control group (a reverse hybrid is an entity which is transparent for tax purposes in its own country but treated by an owner as a separate entity);
- recommendation 5 proposes modifications to the existing domestic law rules to prevent reverse hybrid mismatches being available;
- recommendation 6 deals with payments by branches or hybrid entities which are deductible in two countries;
- recommendation 7 deals with payments by dual resident companies which can be deductible in two countries;
- recommendation 8 deals with imported mismatch payments, which are ordinary payments that can be regarded as funding hybrid mismatch payments in the same group that do not directly impact on New Zealand;
- Recommendations 9-12 support the earlier recommendations, and relate to design and definitions.

15. An overview of the recommendations (with description and proposed counteraction) is in Appendix 1.

Submissions on the hybrids discussion document and our response

16. In our previous report, we noted that while most submitters accepted the need for some hybrid rules, they also advocated a targeted or phased approach to New Zealand's implementation of the OECD hybrids package, focussing on countering arrangements of the most concern to New Zealand.

17. On balance, we are not convinced by these submissions, and recommend implementing the full suite of OECD rules, subject to modifications summarised below. We note that some of the rules only require minor legislative amendment, as they are already part of our law.

18. The reasons for making this recommendation are set out fully in our report on submissions. In summary, we believe that enacting the OECD rules will:

- improve fairness;

- reduce harmful distortions in investment patterns; and
- have a negligible effect on the cost of capital in New Zealand, particularly given the adoption of the rules by the UK, Australia and the EU;
- (as compared to a partial adoption)
 - avoid the need for further piecemeal amendments
 - avoid giving the appearance of blessing those mismatches not dealt with;
- involve acceptable compliance costs, particularly given
 - the expectation that the effect of the rules in most cases will be to drive taxpayers to simpler non-hybrid arrangements (an important exception is branch structures, which are discussed in detail in this report);
 - the adoption of similar rules by other countries.

19. It is also important to appreciate that tax avoidance and tax planning using a range of hybrid structures is well known in New Zealand.

- The bank conduit cases (*Westpac Banking Corporation v CIR* (2009) 24 NZTC 23,834 and *BNZ Investments Ltd v CIR* (2009) 24 NZTC 23,582), the optional convertible note structures (see *Alesco New Zealand Ltd v CIR* (2013) 26 NZTC) and certain mandatory convertible note disputes are all examples of hybrid financial instruments, the subject of OECD recommendations 1 and 2. While they were all held to be ineffective under the general anti-avoidance provision, the process to get to that point was often protracted and economically inefficient. Hybrid rules would have made these transactions clearly tax-ineffective, and they would not have occurred if we had such rules;
- Arrangements are currently in place which exploit hybrid mismatches but are not generally subject to the general anti-avoidance provision. Examples are:
 - The deductible/frankable instruments issued by Australian owned banks out of New Zealand – again these are hybrid financial instruments subject to OECD recommendations 1 and 2;
 - Financing through Australian limited partnerships, which generate double deductions – this is an example of a hybrid payer mismatch subject to OECD recommendation 6;
 - Investment into New Zealand using New Zealand incorporated companies with unlimited liability. Unlimited liability companies can be treated as transparent for US tax purposes, leading to deduction/no inclusion mismatches dealt with under OECD recommendation 3;
- Going further back, New Zealand has also experienced tax planning using dual resident company double deduction arrangements, subject to OECD recommendation 7. As a result we now have provisions which deal with most, but not all, of the hybrid mismatches which can arise from dual resident companies.

20. Mismatches that we are not aware of being used more than rarely are structures that use:

- payments to reverse hybrids subject to OECD recommendation 4, although under current settings there is no particular reason for Inland Revenue to look for them;
- reverse hybrid entity mismatches to achieve double non-taxation of outbound investment (which would be subject to OECD recommendation 5.1);
- imported mismatches (subject to OECD recommendation 8), where funding is channelled into New Zealand using a structure where there is a hybrid mismatch occurs higher up the funding chain, in a transaction not directly involving a New

Zealand taxpayer. We are aware of one such structure and there may be more since, under current settings, there is no particular reason for Inland Revenue to look for them;

- branch mismatches other than those subject to recommendation 6.

21. Despite the fact that not all the types of mismatches dealt with in the OECD Report are currently seen in New Zealand, we consider that given the history touched on in paragraph 19, it is likely that some of the hybrid mismatches that are not addressed in New Zealand's response will be exploited at some point in the future. Addressing everything comprehensively now means the process of amending the legislation will be a very large and complex project that will have to be undertaken alongside the other BEPS projects in a relatively short timeframe. However, as stated above, on balance officials recommend implementing a comprehensive set of hybrid rules.

22. As will be evident from this report, the hybrid rules are complex, and require amendment to many aspects of our tax law. It is important to emphasise that for the vast majority of businesses they should have no impact whatsoever. The hybrid rules will have no impact on purely domestic firms owned by New Zealand residents. Even of those firms that are international, most do not enter into hybrid arrangements directly with New Zealand. Those who do have mostly done so because of the existing tax benefits. Once those benefits are removed, they will likely revert to much simpler and less costly structures. Where application of the rules is unavoidable, for example in relation to New Zealand businesses with foreign branches, we have paid particular attention to simplicity and compliance costs.

Significant issues

23. In this section we have highlighted the recommendations which are likely to attract most comment from submitters, and are therefore significant for more than merely technical reasons.

Application of hybrid rules to foreign branches

24. Particularly in the course of our recent workshop consultations, submitters were very concerned about the fact that the hybrid rules can deny a New Zealand company the ability to reduce the tax on its New Zealand income by offsetting against that income the loss from a foreign branch.

25. We have made various modifications to the OECD proposals to address this issue, including ensuring there is clearly no loss denial for taxpayers who have not entered into more complex structures. However, these modifications may not be to the satisfaction of all in the business or advisory community. In particular, some submitters wanted a de minimis rule of some sort, but we consider our suggested modification to make it clear that simple structures are not impacted by the hybrid rules makes this unnecessary.

Application of hybrid rules to foreign trusts

26. We recommend that the hybrid rules should apply to income of a New Zealand trustee of a foreign trust. This may make it less attractive for New Zealand residents to act as trustees of trusts with non-resident settlors and non-resident assets.

27. As a result of the recommendations of the 2016 Government Inquiry into Foreign Trust Disclosure Rules (Shewan Report), foreign trusts with New Zealand trustees have recently been required to comply with new and more thorough registration and disclosure requirements. This is likely to lead to a significant diminution in the number of such trusts, but we expect there will still be a sizeable number in existence – the number will not be known until 30 June, which is the due date for the new registrations.

28. It is likely that the foreign trust service providers will object to foreign trusts being subject to the hybrid rules. This could be on:

- a technical basis; and/or
- the basis that they have now spent the time and effort to become fully compliant with internationally best-practice disclosure requirements. They may argue it would be unfair for the Government to then make a substantive tax change which for many would make their efforts redundant.

29. We have outlined two options to address the potential hybrid mismatches arising from foreign trusts in paragraphs 123 to 128 below.

Imported mismatches

30. The OECD recommends that countries include imported mismatch rules. These deny a deduction for a payment which is not directly a mismatch between the New Zealand payer and the payee, but which funds the payee (or a higher level “payee”) to make a payment in a hybrid mismatch to a person not directly transacting with the New Zealand taxpayer. Many submitters viewed this as over-reach, highly complex and impractical.

31. We have responded to these submissions by recommending that the imported mismatch rule be enacted in full, but that its implementation be partially deferred.

- When the payment from New Zealand is part of a structured arrangement which includes a hybrid mismatch, applying the imported mismatch rule is both more straightforward and more important to the integrity of the rules. We recommend that this structured aspect of the rule be implemented along with the rest of the hybrid rules.
- When the payment from New Zealand is not part of a structured arrangement, applying the rule is more difficult and less important to the integrity of the New Zealand rules. Delaying the implementation of this rule until there are more countries that have hybrid rules would be sensible. We suggest a delay until 1 January 2020, by which date the EU countries, the UK, and Australia should all have hybrid rules.

Over-taxation by reason of the imposition of NRWT

32. There is no doubt that if a deduction is permanently denied under the hybrid rules for a payment where New Zealand also imposes non-resident withholding tax, there is an element of over-taxation.

33. The OECD does not recommend any adjustment be made to prevent this over-taxation. The UK has followed this approach, though it does not apply withholding tax as widely as New Zealand. Australia has not shown any interest in departing from the OECD approach. Accordingly, there are strong precedents for not addressing this issue.

34. This approach can be justified on the basis that in the majority of cases there should be simpler alternatives to hybrid arrangements giving rise to NRWT. Furthermore, in the case of hybrid financial instruments, if the payee country adopts recommendation 2, there will be no denial under recommendation 1, and therefore no over-taxation. This is expected to resolve the issue in most cases where a New Zealand taxpayer makes a payment under a hybrid financial arrangement to an Australian payee.

35. Nevertheless, we recommend that in the case of a hybrid financial instrument denial, we consider whether taxpayers could be permitted to treat the payment as a dividend. This would allow them to eliminate NRWT by attaching imputation credits to the payment. We need to give further consideration to the flow on effects of this recommendation.

36. This recommendation is likely to go some way to addressing submitters' concerns on hybrid financial instruments, if upon further consideration the measure proceeds. However, they may still be concerned about the treatment of other non-deductible amounts.

Grandparenting for certain instruments issued by banks to the public

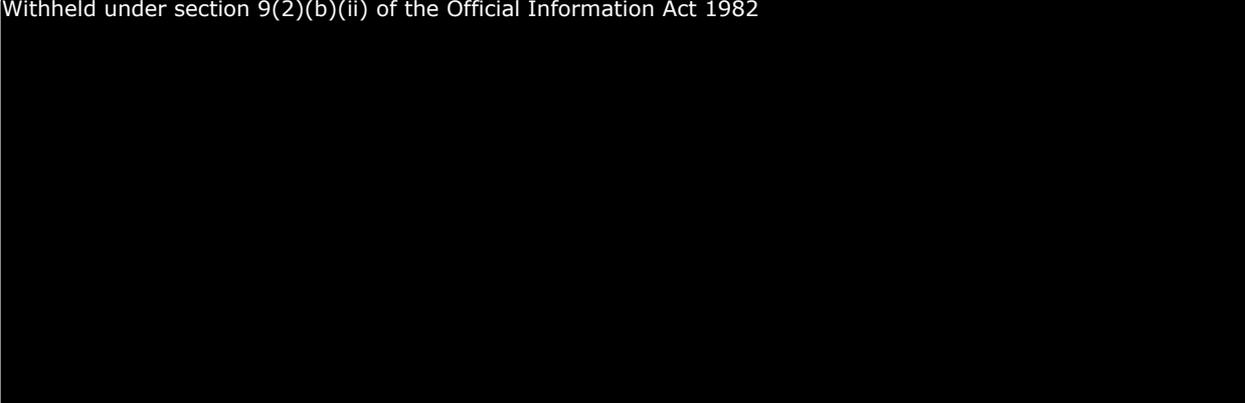
37. Generally the hybrid rules will apply to income and deductions arising after the effective date (expected to be some time on or after 1 July 2018), without regard to when the arrangement giving rise to that amount was entered into. This is the OECD recommendation, which was followed by the UK, and is proposed in the EU and Australia.

38. We recommend an exception for certain hybrid instruments (“regulatory capital hybrids”) issued by banks and insurance companies either directly or indirectly to third party investors, mostly in Australia, in partial satisfaction of the capital requirements imposed on those companies by regulators. We recommend that instruments issued before the discussion document was released (6 September 2016) should not be subject to the hybrid rules until after the first date on which the issuer has an unconditional right to call or otherwise cancel the instruments without penalty.

39. No special treatment was proposed for such instruments in our discussion document. However, we received submissions that such instruments either should not be subject to the hybrid rules at all, or that if they were so subject, there should be some grandparenting relief. Generally the latter submission was based on the publicly issued nature of the instruments. Mostly, the hybrid rules only apply to arrangements between parties who are related or in the same group.

40. Australia announced that it would apply the hybrid rules to such instruments on its Budget day this year. For that reason, it has decided to grandparent regulatory capital instruments issued before 8 May 2017.

Withheld under section 9(2)(b)(ii) of the Official Information Act 1982



Opaque election for foreign hybrid entities

42. The private sector has proposed that New Zealand investors in foreign hybrids be entitled to elect to treat the entity as tax opaque (like a company) in New Zealand. This would mean the New Zealand tax treatment would match the company treatment overseas. This opaque election would take the entity outside the scope of the rules and achieve roughly the same tax effect with lower compliance costs.

43. This opaque election regime, if included in the rules, is most likely to be used by an Australian limited partnership, which is treated as flow-through by New Zealand such that its income and expenditure is attributed to its partners.

44. Administratively, this would likely require some sort of declaration made to the Commissioner. Our current thinking is this declaration would be irrevocable and would continue to apply in the event of a change of ownership. Officials are still working through the details of this idea and whether to recommend its inclusion in the rules. If it does not form part of the final package, this may be viewed unfavourably by the private sector.

Application of rules to branch mismatch arrangements

45. Taxpayers may be concerned to hear that “branch mismatches” are subject to the hybrid rules, since branches are relatively common for a business to have. Accordingly it may be important to be clear about the limits of branch mismatches.

46. Branch mismatches arising from foreign branch losses are a double non-taxation risk. The remainder of the branch mismatch concerns are very unlikely to arise in a New Zealand context. They will apply mostly to deny a deduction for a payment made by a New Zealand taxpayer to a foreign member of the same control group, if that payment is not taxed to the foreign member due to conflicts in branch tax rules between two countries other than New Zealand.

De minimis rule

47. Officials are not recommending a general de minimis for the hybrid rules. The reason for this is that we are comfortable that the proposals will ensure that simple offshore branch structures are not within the scope of the rules. In addition, a de minimis may cause additional complexity given that other countries are not proposing a de minimis in their hybrid mismatch rules.

48. However, officials have provided for a specific de minimis-type rule for reverse hybrid entities established in New Zealand (likely to be limited partnerships and foreign trusts).

Recommended action

We recommend that you:

- (a) **Agree** that a Cabinet paper should be prepared recommending that the general principles of proposals to counteract hybrid mismatches in line with the recommendations in the OECD *Neutralising the Effects of Hybrid Mismatch Arrangements* report are drafted into a bill, subject to the modifications and further detail contained in this paper.

Agreed/Not agreed

Agreed/Not agreed

- (b) **Agree** that the Cabinet paper in recommendation (a) should delegate authority to the Minister of Finance and the Minister of Revenue for the detailed design relating to the general principles of the hybrid mismatch arrangements rules discussed in the recommendations below.

Agreed/Not agreed

Agreed/Not agreed

OECD recommendations 1 and 2: general principles

- (c) **Agree** the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principles in accordance with OECD recommendations 1 and 2:
- a. In relation to a payment under a financial instrument between related parties or that is a structured arrangement, and that results in a hybrid mismatch:
 - (i) deny a New Zealand payer a deduction for the payment to the extent it is not taxed to a non-resident payee (recommendation 1 primary rule);
 - (ii) if a non-resident payer has not been denied a deduction for the payment under similar rules, tax a New Zealand payee on the payment as ordinary income, with no entitlement to a tax credit (recommendation 1 defensive rule)

Agreed/Not agreed

Agreed/Not agreed

- b. Expand the current rule which denies a dividend exemption to a deductible dividend paid by a foreign company to a New Zealand company so that it also applies if the foreign payer receives tax benefits similar in nature to a deduction (recommendation 2)

Agreed/Not agreed

Agreed/Not agreed

OECD recommendations 1 and 2: detailed design

- (d) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (c) are effective:

- a. A person who receives a payment which is deductible to the payer in another country should not be entitled to the benefit of any imputation credit attached to the payment.

Agreed/Not agreed

Agreed/Not agreed

- b. When the hybrid rules apply to a hybrid financial instrument issued by a New Zealand taxpayer and denominated in a foreign currency:
- (i) the deduction denied should take into account any foreign currency fluctuations on the instrument which would otherwise be taken into account for tax purposes;
 - (ii) any net income from the instrument including any foreign currency fluctuations should be non-taxable.

Agreed/Not agreed

Agreed/Not agreed

- c. When the hybrid rules apply to a hybrid financial instrument held by a New Zealand taxpayer and denominated in a foreign currency, the person should not take into account any foreign currency fluctuations on the instrument, unless the instrument is an interest in a FIF which is subject to the comparative value method.

Agreed/Not agreed

Agreed/Not agreed

- d. To the extent that a payment on a hybrid financial instrument can be proven to give rise to taxation of an investor in the payee country under another country's controlled foreign company (CFC) regime, the payer should be allowed a deduction for the payment.

Agreed/Not agreed

Agreed/Not agreed

- e. If a New Zealand resident share lender lends shares in a transaction subject to the hybrid rules:
- (i) Officials should give further consideration to whether the lender should be taxable on a dividend substitution payment (since such a payment will generally be deductible to the payer);
 - (ii) The lender not be allowed an imputation credit on any replacement payment in respect of New Zealand shares, if the share borrower is entitled to a deduction for that payment.

Agreed/Not agreed

Agreed/Not agreed

- f. If a person holds, pursuant to a share repo arrangement:
- (i) a FIF interest, that person should be required to use the comparative value or attributed foreign income method to determine their income from the FIF interest;
 - (ii) New Zealand shares, where the borrower is a non-resident the person is not entitled to the benefit of an imputation credit attached to any replacement payment which is deductible to the borrower.

Agreed/Not agreed

Agreed/Not agreed

- g. OECD recommendation 1 should only apply to deny a deduction, or include amounts in income, as a result of a timing mismatch between resident and non-resident parties if:
- (i) the mismatch arises on an instrument with a term of 3 years or more or which has been extended to beyond 3 years; and
 - (ii) the mismatch is in relation to a payment which the lender is not accounting for, for tax purposes, on a reasonable accrual basis; and
 - (iii) it is not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months of the end of the period in which the expenditure is incurred.

Agreed/Not agreed

Agreed/Not agreed

- h. Officials give further consideration to the idea that, when a person makes a payment under a hybrid financial arrangement for which a deduction is denied under the hybrid rules, the person may choose at the time of making the payment to treat it as a dividend for purposes of both (but not one only) of the non-resident withholding tax and imputation credit rules.

Agreed/Not agreed

Agreed/Not agreed

- i. Amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is denied or deferred under OECD recommendation 1 are not taken into account unless and until they are deducted.

Agreed/Not agreed

Agreed/Not agreed

- j. Clarify, if necessary, that interest that is permanently denied a deduction under recommendation 1 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed

Agreed/Not agreed

- k. There should be no exclusion for regulatory capital issued by banks and insurance companies except for some issues made before the release of the discussion document (6 September 2016).

Agreed/Not agreed

Agreed/Not agreed

OECD recommendation 3: general principles

- (e) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principles, in accordance with OECD recommendation 3, in relation to payments made to a person in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not recognized under the tax law in the payee country because the payment is disregarded under that law:
- a. deny a deduction for the payment if made by a New Zealand payer (recommendation 3 primary rule);
 - b. if the payment is made by a non-resident, who is not denied a deduction under similar rules, to a New Zealand resident, include the payment in ordinary income of the New Zealand resident (recommendation 3 defensive rule);
 - c. allow any such deduction or income inclusion to be reversed to the extent that the deduction to the payer is set off against dual inclusion income.

Agreed/Not agreed

Agreed/Not agreed

OECD recommendation 3: detailed design

(f) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (e) are effective:

- a. in applying the primary rule only, the amount for which a deduction is denied should take into account any foreign currency fluctuations recognized for tax purposes in relation to a financial arrangement denominated in a foreign currency

Agreed/Not agreed

Agreed/Not agreed

- b. dual inclusion income should be calculated in accordance with New Zealand tax principles on the income of the hybrid payer from activities that are taxed in New Zealand, except that it should not include income which is protected from New Zealand tax by a foreign tax credit

Agreed/Not agreed

Agreed/Not agreed

- c. for purposes of the primary rule, full taxation of income under a CFC regime should:
- (i) prevent income being treated as not taxable to a payee, and
 - (ii) qualify income as dual inclusion income where it is not otherwise taxed to the payee and is not sheltered from tax by a foreign tax credit.

Agreed/Not agreed

Agreed/Not agreed

- d. when an amount of deemed hybrid income is reversed in a later year because it is offset against dual inclusion income, that should be taken into account in determining the limit on the amount of foreign tax credit for which a New Zealand taxpayer applying the defensive rule is eligible

Agreed/Not agreed

Agreed/Not agreed

- e. the ability to claim a deduction in relation to a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred (primary rule) or deemed expenditure arose (defensive rule)

Agreed/Not agreed

Agreed/Not agreed

- f. amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendation 3 are not taken into account unless and until they are deducted

Agreed/Not agreed

Agreed/Not agreed

- g. denial of a deduction for interest under recommendation 3 will not affect the amount of recognised interest or amount of debt for the purposes of the thin capitalisation rules;

Agreed/Not agreed

Agreed/Not agreed

- h. a deduction be denied where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs

Agreed/Not agreed

Agreed/Not agreed

- i. where a New Zealand taxpayer has recognized income as a result of receiving a disregarded payment from a foreign hybrid entity, that income should be reversed in a later year when there is dual inclusion income earned through the hybrid entity

Agreed/Not agreed

Agreed/Not agreed

OECD recommendation 4: general principle

- (g) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand implement the following general principle, in accordance with recommendation 4, in relation to payments made to a reverse hybrid entity in the same control group as the payee or pursuant to a structured transaction, where the payment is deductible to the payer but not included as income under the tax law in the reverse hybrid establishment country or in the country of the entity or person investing in the reverse hybrid:

- a. deny a deduction for the payment if made by a New Zealand payer (recommendation 4);

Agreed/Not agreed

Agreed/Not agreed

OECD recommendation 4: detailed design

(h) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (g) are effective:

- a. Diverted branch payments and payments made to a disregarded branch are included within the scope of recommendation 4.

Agreed/Not agreed

~~Agreed/Not agreed~~

- b. Recommendation 4 deduction denial in respect of a payment under a foreign currency loan includes foreign currency gains or losses.

Agreed/Not agreed

~~Agreed/Not agreed~~

- c. To the extent a payment to a reverse hybrid can be proven to be taxed under the CFC regime of an investor country, a deduction will be allowed.

Agreed/Not agreed

~~Agreed/Not agreed~~

- d. Non-resident withholding tax should continue to be applied to payments, despite the denial of the deduction.

Agreed/Not agreed

~~Agreed/Not agreed~~

- e. Clarify that interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed

~~Agreed/Not agreed~~

OECD recommendation 5.1

- (i) **Agree** that Officials give further consideration to whether New Zealand should modify its controlled foreign company (CFC) rules to include as attributable foreign income all income of the reverse hybrid which would have been taxed to the New Zealand investor had it derived the income directly but which is not taxed by the country of the entity because the entity is fiscally transparent (recommendation 5.1).

Agreed/Not agreed

~~Agreed/Not agreed~~

OECD recommendation 5.2

- (j) **Agree** that the Cabinet paper in recommendation (a) should recommend that New Zealand restrict the tax transparency of reverse hybrids established under New Zealand law (recommendation 5.2) by taxing the partnership income of a non-resident partner of a New Zealand limited partnership if:
- a. the total foreign-sourced income of the limited partnership exceeds the greater of \$10,000 or 20% of the total reverse hybrid income; and
 - b. the non-resident partner is in a control group with the partnership; and
 - c. the non-resident partner is not taxed on their share of the income of the partnership because their jurisdiction views the income as earned by the partnership and not the partner.

- (k) **Agree** that:

Inland Revenue recommendation

The Cabinet paper in recommendation (a) should recommend that New Zealand restrict the tax transparency of reverse hybrids established under New Zealand law (recommendation 5.2) by taxing the foreign source beneficiary income of a non-resident beneficiary of a trust with a New Zealand trustee if:

- a. the total foreign-sourced income of the trust exceeds the greater of \$10,000 or 20% of the total reverse hybrid income; and
- b. the non-resident beneficiary is in a control group with the trust; and
- c. the non-resident beneficiary is not taxed on their share of the foreign source income of the trust in their residence country because that country views the income as earned by the trustee and not the beneficiary.

Agreed/Not agreed

Agreed/Not agreed

Or

Treasury recommendation

New Zealand should tax the New Zealand and foreign sourced income of a trustee if either the settlor is resident in New Zealand or the trustee is resident in New Zealand, subject to transitional relief for a foreign trustee that migrates to New Zealand to give time to arrange a new trustee for the trust.

Agreed/Not Agreed

Agreed/Not agreed

Or

The tax treatment of trusts should stay as it is.

Agree/Not agreed

Agreed/Not agreed

OECD recommendation 6: general principles

- (l) **Note** that in Budget 2017 Cabinet agreed to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand (CAB-17-MIN-0164 refers).

Noted

Noted

- (m) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principles, in relation to recommendation 6, and consistent with the Budget 2017 decision on foreign hybrid entity double deductions:
- a. disallow the losses of a New Zealand-owned foreign hybrid entity or foreign branches if there is another entity in that foreign country whose income is:
 - (iii) capable of being offset against the losses of the hybrid entity or branch; and
 - (iv) not taxable in New Zealand (recommendation 6 primary);
 - b. disallow the losses of a foreign-owned New Zealand hybrid entity or branch if the owner of the branch is not denied the loss under recommendation 6 primary rule in another country (recommendation 6 defensive);
 - c. do not disallow losses (or reverse any previous disallowance) to the extent that the hybrid entity or branch earns dual inclusion income.

Agreed/Not agreed

Agreed/Not agreed

Detailed design

- (n) **Agree** to the following detailed rules to ensure that the general principles contained in recommendations (m) are effective:
- a. provide for a transitional rule such that a New Zealand-owned foreign hybrid entity or foreign branch's accumulated loss is recaptured where that entity or branch's control group acquires an interest in an entity in the foreign country except in cases where the accumulated loss cannot be offset against current and future income of the newly acquired entity

Agreed/Not agreed

Agreed/Not agreed

- b. allow a deduction in New Zealand for losses of New Zealand-owned foreign hybrid entities or foreign branches if those losses cannot ever be used in the foreign country

Agreed/Not agreed

Agreed/Not agreed

- c. income which can be shown to be taxable in the foreign country and in New Zealand under New Zealand's CFC rules can be regarded as dual inclusion income except to the extent that the income is sheltered by a foreign tax credit

Agreed/Not agreed

Agreed/Not agreed

- d. double deduction amounts and dual inclusion income amounts for a foreign hybrid entity or branch should be calculated in accordance with New Zealand tax principles on the income of the foreign hybrid entity/branch/ from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit should not be regarded as dual inclusion income

Agreed/Not agreed

Agreed/Not agreed

- e. the ability to claim a deduction in relation in a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred (recommendation 6 primary rule) or deemed expenditure arose (recommendation 6 defensive rule)

Agreed/Not agreed

Agreed/Not agreed

- f. amendments be made to the non-resident withholding tax rules so that in determining whether the rules require tax to be withheld on an accrual (rather than payments) basis, amounts for which a deduction is deferred under OECD recommendations 6 are not taken into account unless and until they are deducted

Agreed/Not agreed

Agreed/Not agreed

- g. denial of a deduction for interest under recommendations 6 will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules;

Agreed/Not agreed

Agreed/Not agreed

- (o) **Agree** that officials consider further whether it is possible to design a tightly targeted and simple optional regime whereby foreign hybrid entities can elect to be treated as opaque entities for New Zealand tax purposes

Agreed/Not agreed

~~Agreed~~/Not agreed

OECD recommendation 7: general principles

- (p) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principle, in relation to recommendation 7:

Disallow a deduction claimed in New Zealand by a dual resident company except to the extent that the dual resident company earns dual inclusion income

Agreed/Not agreed

~~Agreed~~/Not agreed

OECD recommendation 7: detailed design

- (q) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (p) are effective:

- a. New Zealand amend its existing rules as to consolidation and loss grouping of dual resident company losses to ensure that those losses cannot be offset against income earned by a New Zealand reverse hybrid.

Agreed/Not agreed

~~Agreed~~/Not agreed

- b. double deduction amounts and dual inclusion income amounts should be calculated in accordance with New Zealand tax principles on the income of the dual resident company from activities that are taxed in New Zealand, except that income which is protected from New Zealand tax by a foreign tax credit should not be regarded as dual inclusion income.

Agreed/Not agreed

~~Agreed~~/Not agreed

- c. the ability to claim a deduction in relation in a later year due to future dual inclusion income should be lost if there is a more than 51% change in a company's ownership since the time the relevant deduction was incurred

Agreed/Not agreed

~~Agreed~~/Not agreed

- d. denial of a deduction for interest will not affect the amount of recognised interest or amount of debt for the purposes of thin capitalisation rules

Agreed/Not agreed

Agreed/Not agreed

OECD recommendation 8: general principles

- (r) **Agree** that the Cabinet paper referred to in recommendation (a) should recommend that New Zealand implement the following general principle, in relation to recommendation 8:

- a. deny a deduction in New Zealand for any payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand;

Agreed/Not agreed

Agreed/Not agreed

- b. do not deny deduction such a deduction if the payment is made to a country that has hybrid mismatch rules

Agreed/Not agreed

Agreed/Not agreed

OECD recommendation 8: detailed design

- (s) **Agree** to the following detailed rules to ensure that the general principles contained in recommendation (r) is effective:

- a. When recommendation 8 applies to a payment that imports an offshore hybrid or branch mismatch arrangement into New Zealand, the deduction denied should ignore any foreign currency fluctuations on the instrument.

Agreed/Not agreed

Agreed/Not agreed

- b. Clarify that interest that is denied a deduction under recommendation 4 and the debt under which that interest paid is disregarded for the purposes of the thin capitalisation rules.

Agreed/Not agreed

Agreed/Not agreed

OECD recommendations 9-12: general design and definitional matters

- (t) **Agree** that a coordination rule be included in the hybrid rules to ensure that the hybrid mismatch rules of other countries mesh well with New Zealand's rules.

Agreed/Not agreed

Agreed/Not agreed

- (u) **Agree** that a specific anti-avoidance rule be included in the hybrid rules to allow the Commissioner of Inland Revenue to counteract arrangements that have the purpose or effect of defeating the intent or application of the hybrid rules.

Agreed/Not agreed

Agreed/Not agreed

- (v) **Note** that, consistent with the Budget 2017 Cabinet paper (CAB-17-MIN-0164 refers), the hybrid rules should generally apply from 1 July 2018.

Noted

Noted

- (w) **Agree** that the effective date of rule relating to unstructured imported mismatches which should be delayed until 1 January 2020.

Agreed/Not agreed

Agreed/Not agreed

- (x) **Agree** that the effective date of the rules relating to limited partnerships and foreign trusts which are reverse hybrid entities (subject to the decision at Recommendation 5.2 (k) on foreign trusts above) should be income years beginning on or after 1 April 2019

Agreed/Not agreed

Agreed/Not agreed

- (y) **Agree** that there will be no general grandparenting of hybrid instruments or entities from the application of the hybrid mismatch rules, with the exception of hybrid financial instruments which are entitled to grandparented tax treatment until their next call date provided that they are:

- a. issued directly to, or are traceable to, issues to the public; and
- b. issued before the release of the Government's *Addressing Hybrid Mismatch Arrangements* discussion document on 6 September 2016.

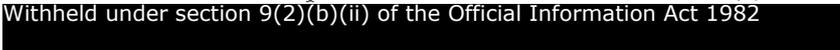
Agreed/Not agreed

Agreed/Not agreed

(z) **Note** that the fiscal impact of agreeing to recommendation (y) is an estimated revenue increase of approximately \$71 million over the four years from 2018/19 to 2021/22.

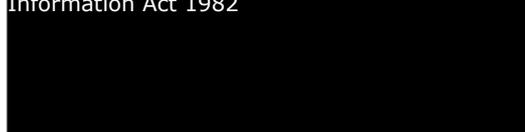
Noted



(aa) **Note** that the fiscal impact set out in recommendation (z) is contingent on 
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Noted



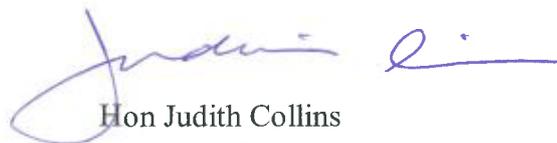
Withheld under section 9(2)(a) of the Official Information Act 1982


Matthew Gan
Tax Specialist
The Treasury



Paul Kilford
Policy Manager
Policy and Strategy
Inland Revenue

Steven Joyce
Minister of Finance



Hon Judith Collins
Minister of Revenue

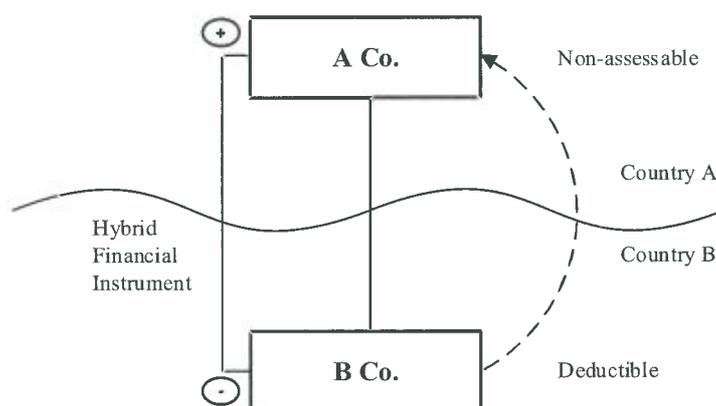
Detailed recommendations

49. We now set out our recommendations for implementing hybrid rules in New Zealand.

Hybrid financial instruments (OECD recommendations 1 and 2)

General

50. We recommend that New Zealand introduce rules, in line with OECD recommendations 1 and 2, to prevent double non-taxation arising from hybrid financial instruments. The following diagram illustrates a typical hybrid financial instrument.



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

51. The OECD recommends that in relation to payments made in connection with financial instruments, countries (in the following order):

- tax dividend payments as ordinary income, if the payments are deductible to the foreign payer (recommendation 2);
- deny a deduction for a payment which is not taxed as ordinary income to the foreign payee and therefore subject to no or a reduced amount of foreign tax (recommendation 1 primary rule); and
- if a payment which is not taxed as ordinary income is deductible to the payer in another country (i.e. that country has not implemented the primary rule), impose tax on that payment as if it were ordinary income (recommendation 1 defensive rule)¹.

52. Recommendation 1 applies only to arrangements between related parties, or which are structured.

¹ If a country has enacted recommendation 2, the defensive response under recommendation 1 would only apply in relation to mismatches where the payee is not treated as receiving a dividend. An example is a sale of property with deferred payment, where the buyer is entitled to a deduction for deemed interest, but the seller is not taxable on that amount as ordinary income.

Recommendations relating to OECD recommendation 2

53. New Zealand already has a rule achieving most of the OECD recommendation 2. This rule denies the general exemption for dividends received by a New Zealand company from a foreign company, if the dividend is deductible to the payer. To ensure that this rule is fully effective, we recommend that it be expanded to:

- tax a dividend if the payment of the dividend triggers a tax credit for the payer in its country of residence, giving the same effect as a deduction, This is proposed in the OECD Final Report² and our discussion document; and
- where a deductible dividend has an imputation credit attached, deny the payee the ability to use the imputation credit to reduce their tax liability. The Australian Government announced in its recent Budget that it would also be making this change.

Instruments denominated in a foreign currency

54. We recommend that when the instrument is denominated in a foreign currency (e.g. a loan in a foreign currency), the amount of the recommendation 1 primary rule denial includes the effect of foreign currency gain or loss. Under New Zealand's comprehensive financial arrangements rules, foreign currency gain or loss on a financial arrangement is taxable and (subject to the usual restrictions) deductible, often on an accrual basis. If the arrangement is a hybrid financial instrument in respect of which a deduction for interest is denied under recommendation 1 primary rule, we recommend that this also apply to the foreign currency loss or gain. In the case of a gain, this means the gain is tax exempt. This approach will simplify compliance and is consistent with the conceptual basis for financial arrangement taxation and the hybrid rules. This approach was widely supported in our workshop consultation.

55. We do not recommend taking the same approach to income inclusion under recommendation 2 (except insofar as that will occur through application of the comparative value method under the FIF rules) or the recommendation 1 defensive rule. In those cases, only the actual amount of the deductible payment should be included in the payee's income. Since the payee is not otherwise recognising income in these cases, there is no compliance saving from including foreign currency in the counteraction. Currently, when we apply our domestic rule that corresponds to recommendation 2, we do not include foreign currency, and this does not seem to have caused any difficulty. This approach was also widely supported in workshop consultation.

Whether CFC taxation in a third country is treated as income inclusion

56. We recommend that to the extent that a payment on a hybrid financial instrument can be shown to give rise to taxation of an investor in the payee under another country's controlled foreign company (CFC) regime, the payer should be allowed a deduction for the payment. This was strongly supported in consultation. However, given the complexity involved in demonstrating that this is the case, we recommend that taxpayers who believe a deduction is justified on this basis be required to indicate that (including stating the amount of the

² We understand this is based on a tax treatment that applies in Malta.

deduction so justified) when filing their tax return, so the Commissioner is alerted and can audit this claim if she wishes to do so.

Hybrid transfers

57. OECD recommendation 1 is intended to apply to financial instrument lending and financial instrument repo arrangements. We recommend that New Zealand's rules also apply to these transactions. This appears to require a number of technical amendments to the current rules.

58. In relation to share lending (see glossary at Appendix 2) by a New Zealand resident share lender who lends shares in a transaction subject to the hybrid rules (which means it must be with a related party or be a structured arrangement):

- we are considering whether to require that the lender be taxable on a dividend substitution payment, since such a payment will generally be deductible to the payer. This will require over-riding their current ability to use the fair dividend rate method, as if they continued to own the shares;
- we recommend that the lender not be allowed an imputation credit on any replacement payment in respect of New Zealand shares, if the share borrower is entitled to a deduction for that payment.

59. In relation to share repos (see glossary at Appendix 2) we recommend in particular that regardless of whether the transaction is structured or between related parties:

- when the shares are subject to the FIF rules, the money lender (who acquires the shares under the repo, and must re-deliver them at the end of the arrangement) be required to use the comparative value method to determine its income from the shares. This is the same treatment as applies in other situations where shares produce a debt-like return; and
- when the shares are New Zealand shares, the money lender not be entitled to an imputation credit with respect to the dividend. This is already the case as a practical matter, but it ensures that foreign borrowers are not subject to the hybrid rules with respect to any payment they are deemed to make to a New Zealand lender under a share repo.

60. We have consulted on these recommendations both generally and with the Crown entities engaged in share lending. The Crown entities do not see any difficulty with them.

Timing

61. A timing mismatch arises where payments under an instrument are taxable and deductible, but the payer is entitled to a deduction much earlier than the payee has to return income. The OECD recommendation is that timing mismatches should give rise to a hybrid counteraction under recommendation 1 only where the mismatch is not corrected within 12-24 months and there is no reasonable expectation that it will not be corrected within a reasonable period of time. Mismatches arising only from foreign currency movements will not bring an instrument into this rule.

62. We recommend a more clear-cut, less discretionary rule. Under this rule, a timing mismatch would be counteracted under the hybrid rules if it is:

- on an instrument with a term of 3 years or more or which has been extended to beyond 3 years; and
- in relation to a payment for which the lender is not accounting, for tax purposes, on a reasonable accrual basis; and
- not reasonable, having regard to the terms of the instrument and the payments made to date, to believe that the expenditure will be included in income in the payee's accounting period beginning within 24 months of the end of the period in which the expenditure is incurred.

63. If these criteria are met, any timing mismatch will be counteracted, but the counteraction will be reversed as the mismatch reverses. So, for example, a deduction denied under the primary rule will be allowed if and when the income is recognised in the payee country.

64. Our timing approach was widely supported in consultation, and is broadly in line with what we understand Australia is currently proposing.

Interaction with non-resident withholding tax

65. When non-resident withholding tax ("NRWT") (generally at a rate of 10%) is imposed on an interest payment which is non-deductible as a result of the application of OECD recommendation 1, there is an element of double taxation. Taxpayers can avoid this by not issuing hybrid financial instruments. In consultation, this was not regarded as an adequate response to the issue. Accordingly, we recommend that we give further consideration to the idea of allowing taxpayers to choose to treat such a payment as a dividend for withholding tax purposes. The rate of NRWT on a dividend is generally 15%, but this can be reduced or eliminated by attaching imputation credits to the dividend. There are some cases where the rate is as low as 0%. This treatment will have to be elected before the payment is made.

66. We also recommend amending the rules, enacted this year, which prevent deferral of NRWT. These rules apply if a New Zealand borrower from a related party foreign lender calculates its interest expense on an accrual basis, but the relevant interest is not paid for some time, leading to a deferral of the corresponding NRWT. The most significant amendment we propose to this rule is that where interest expense is not deductible under recommendation 1, that interest should not be taken into account when deciding whether or not to apply the anti-deferral rule. This amendment was widely supported in consultation.

Interaction with thin capitalisation regime

67. The thin capitalisation regime denies deductions for a proportion of a group's interest expenses if the group has debt-funded its New Zealand operations above a permissible level. Debt funding will only be taken into account to the extent it gives rise to a deduction. Accordingly, we recommend that where payments under a hybrid financial instrument are subject to permanent deduction denial under recommendation 1 primary rule, they will not be treated as debt for the purpose of this rule. Instruments where there is a timing mismatch would still be treated as debt, but the interest expense would only be subject to the thin

capitalisation rules in the year it is deductible under the hybrid rules. This was supported in consultation, and our initial assessment is that it requires no amendment to the law.

Application to regulatory capital issued by banks and insurance companies

68. Some of the Australian owned banks with New Zealand branches have undertaken significant issues of hybrid financial instruments. These are generally treated as debt in New Zealand but equity in Australia. Although the dividend is taxable in Australia, that tax is generally eliminated because the dividend carries a franking credit which is generated by the payment of Australian tax on other income. These instruments have generally also counted towards the bank's regulatory capital requirements for Australian or New Zealand purposes.

69. We recommend that the New Zealand hybrid rules not exclude regulatory capital (i.e. that required to be issued by banks and insurance companies). The OECD Final Report notes that countries may choose to have such an exclusion. The UK has chosen to do so, though it has other anti-tax arbitrage rules that have applied to bank regulatory capital for some time. Australia has decided not to exclude regulatory capital from its hybrid rules, in its recent Budget. The EU requires member states to include regulatory capital in their hybrid rules by 1 January 2022. Our discussion document also recommended no exclusion.

70. We received several submissions in favour of an exclusion. These submissions and our reasons for not accepting them are contained in Tax Policy Report: Consultation on Addressing Hybrid Mismatches (T2017/406 IR2017/133). Given Australia's decision, New Zealand's position is now largely moot in relation to the trans-Tasman hybrid issues referred to above (with the exception of transitional issues). Because Australia will tax the return on such instruments with no allowance for an imputation credit, New Zealand will continue to allow a deduction.

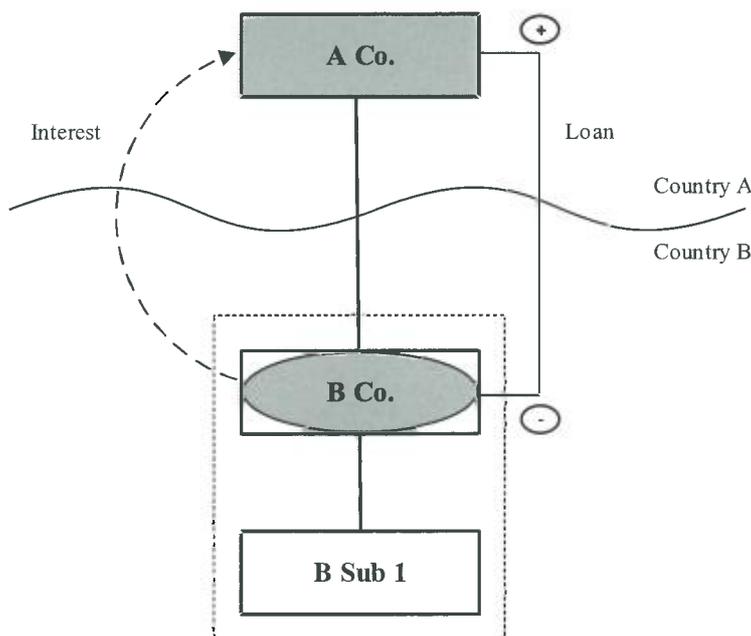
71. We recommend grandparenting from recommendation 1 for deductions claimed in New Zealand by banks and insurance companies in respect of certain capital issued before the release of the discussion document on 6 September 2016. This is discussed more fully under the heading *Effective Date and Implementation*.

Hybrid entities – disregarded payments (OECD recommendation 3)

General

72. We recommend that New Zealand introduce rules in line with OECD recommendation 3 to prevent double non-taxation arising when a hybrid entity makes a payment which is deductible to the payer but disregarded by the payee. A hybrid entity is an entity which is transparent for tax purposes in the country of an investor but opaque for tax purposes in

another country, generally where it is established. A diagram follows, where A Co is the investor and B Co is the hybrid entity.



73. The interest payment by B Co is deductible in the hybrid entity country but disregarded in the investor country. In the New Zealand context, B Co could be a New Zealand company with unlimited shareholder liability, and A Co could be a US company which has chosen to treat B Co as fiscally transparent.

74. Because the interest payment by B Co is deductible in Country B, if B Co has no other income, the payment produces a tax loss, which can be grouped with the income of B Sub 1. The payment can therefore reduce taxable income in Country B without giving rise to any income in Country A, because of the different treatment of B Co in each country. This is a deductible/non-includible mismatch.

75. OECD recommendation 3 is that Country B should defer a deduction for such a payment until it is offset by dual inclusion income (discussed immediately below). This is the primary rule. If it does not defer the deduction, Country A should tax the payment, under the defensive rule. Neither rule applies unless the payer and payee are in the same control group (50% or more commonly owned) or the arrangement is structured.

76. Unlike recommendations 1 and 2, recommendation 3 can apply to any kind of deductible payment, e.g. rent, royalties, payments for services, etc.

77. Denial of a deduction under recommendation 3 should be reversed to the extent that the hybrid entity has dual inclusion income. Dual inclusion income is generally speaking income that is taxable in Country A and Country B. If B Co in the above diagram in the same year earns a separate stream of dual inclusion income equal to the amount of the interest payment, it would have:

- no gain or loss in Country B (since the income and interest offset each other); and

- income equal to the amount of the interest payment in Country A (since the income is taxable with no deduction for the disregarded payment).

78. The existence of taxable income in Country A would mean that the tax result is appropriate without the need to apply any hybrid counteraction.

79. The same outcome should apply if the dual inclusion income is earned in a later year. Accordingly the OECD recommends that deductions denied under recommendation 3 be able to be deducted in a later year if there is dual inclusion income. Accordingly, denial under recommendation 3 is in fact only deferral, though the deferral may be permanent if no dual inclusion income ever arises.

Application to deemed payments by branches

80. In line with the OECD branch mismatch report, we recommend that recommendation 3 also apply where a branch is treated in the branch country as making a deductible payment to its head office which is not a simple allocation of third party costs. So far as policy officials are aware, New Zealand allows a deduction for a deemed payment only in relation to interest on deemed loans by non-resident banks and insurance companies to their New Zealand branches. Where the taxpayer is resident in Australia, our understanding is that the deemed payment is recognised for Australian tax purposes. From a practical perspective, the application of the primary rule of recommendation 3 in a branch context is therefore unlikely.

Carry forward of recommendation 3 defensive counteraction

81. The OECD Final Report does not discuss the possibility of allowing a reversal of amounts of income deemed to arise under the defensive rule in recommendation 3. However, for reasons of principal and consistency, we proposed in our discussion document that where a New Zealand taxpayer has recognised income as a result of receiving a disregarded payment from a foreign hybrid entity, that income should be reversed in a later year when there is dual inclusion income earned through the hybrid entity. We recommend that this reversal be part of the New Zealand hybrids legislation. This is a taxpayer friendly measure, though we do not anticipate the defensive rule often applying in New Zealand.

Foreign currency loans

82. We recommend a similar approach to foreign currency loans subject to recommendation 3 primary rule as the approach set out above in relation to recommendation 1. If the loan is to a New Zealand hybrid, the amount of the deduction subject to denial should take into account foreign currency fluctuations. In this case though, any net income to the NZ hybrid borrower due to foreign currency gain will be taxed as dual inclusion income, rather than exempt.

83. We recommend a different approach to foreign currency loans subject to the recommendation 3 defensive rule to the approach set out above in relation to recommendations 1 and 2. Consistent with the primary rule recommendations, we recommend that foreign currency fluctuations should be taken into account in determining the amount of additional income arising under the defensive rule counteraction. That is because they will also be recognised in determining dual inclusion income, as discussed further below.

Simple implementation solution

84. Foreign currency loans are one aspect of a larger issue in implementing OECD recommendation 3, which arises from the fact that different countries have different rules for calculating income and expense. This poses a challenge for recommendation 3, in particular in relation to the measurement of dual inclusion income.

85. We recommend that dual inclusion income be determined in such a way as to simplify the application of recommendation 3 as far as possible. This means that when applying the primary rule in recommendation 3, dual inclusion income would include all income earned by the hybrid entity from activities the income of which is taxable in the investor country. This income would be calculated in NZ\$ and using New Zealand tax principles, without regard to the amount of income actually returned in the investor country from those same activities.

86. Similarly, when applying the defensive rule, New Zealand would treat as dual inclusion income all income from the hybrid as calculated for New Zealand tax purposes, except where that income is protected from New Zealand tax by a foreign tax credit.

87. This simplifying approach was widely supported in consultation.

Whether CFC taxation in a third country is treated as income inclusion

88. As for the OECD recommendation 1, we recommend that to the extent that a payment by a hybrid entity which is disregarded by the payee can be proven to give rise to taxation of an investor in the payee under another country's CFC regime, the payer should be allowed a deduction for the payment. Similarly, amounts which are included in income under another country's CFC regime can qualify as dual inclusion income. However, because of the complexity of CFC taxation, in these cases, we propose that the taxpayer would have to demonstrate that the amounts are fully taxable for CFC purposes in the relevant period.

89. We do not propose that CFC taxation be taken into account when New Zealand is applying the defensive rule in recommendation 3. That is because in that case any taxation imposed in New Zealand under the hybrid rules should be available as a credit against CFC taxation.

Effect of deferred deductions on foreign tax credit limitation

90. A person's ability to claim a credit against New Zealand income tax for foreign income tax imposed on foreign source income is limited to the amount of New Zealand income tax imposed on the net foreign income, i.e. taking into account deductions claimed in New Zealand in relation to that income.

91. This will naturally mean that when a deduction which has been deferred under recommendation 3 primary rule is later allowed, it will lower the foreign tax credit limitation. We recommend that the same outcome should apply when a New Zealand taxpayer has income under the defensive rule in recommendation 3, and that income is reversed in a later year by virtue of dual inclusion income arising in the hybrid entity.

92. The effect of reversing the recommendation 3 counteraction on the foreign tax credit limitation was discussed in consultation, and generally accepted. Submitters did comment that there are already similar existing anomalies in the calculation of foreign tax credits, some of which give results which are unfavourable to taxpayers, and suggested that a more general policy review of the foreign tax credit rules would be appropriate. However, this would have to be undertaken as a separate policy proposal.

Effect of loss of ownership continuity on carry forwards

93. As set out above, deductions deferred under the recommendation 3 primary rule should be carried forward and allowed when and if there is dual inclusion income in a future year. However, we recommend that if the taxpayer is a company, and there is a 51% or greater change in the taxpayer's ownership after the time when the deduction would ordinarily be claimed, the deductions would not be able to be claimed in the future. The same rule would apply to income deemed to arise under the recommendation 3 defensive rule.

94. This is the same rule as applies to deductions for carried forward losses. It ensures that it is not possible for owners of a company to profit from the sale of the company as a tax shelter. That rationale applies in the case of deductions denied under the hybrid rules in just the same way as it applies to deductions which are unusable in the year incurred because they exceed current income. While such deductions are able to be carried forward and used in future years for the benefit of the shareholders who owned the company when the expenses were incurred, they should not be able to be used for the benefit of other shareholders.

95. One of the reasons for making this recommendation is that in some cases, deductions denied under the recommendation 3 primary rule would, if allowed, have formed part of a net loss to carry forward in any event, and thus been subject to elimination on an ownership change in the ordinary way. It would be anomalous in that case for the hybrid rules to have the effect of protecting the carry forward of those expenses from elimination.

96. While officials' position was understood in consultation, it was not entirely accepted by all parties, and may be subject to a degree of criticism. Submitters felt the deferral of a deduction was more like a timing rule (e.g. cash deduction for an accrued expense) which is not subject to carry forward elimination if there is an ownership change between accrual and deduction.

Interaction with NRWT

97. When a payment for which a deduction is deferred under recommendation 3 is subject to New Zealand NRWT, we do not propose that any adjustment be made for that. Recommendation 3 does not permanently deny the deduction – it defers it until there is income in the hybrid. So it would not be appropriate to adopt the same solution being considered for a payment in a recommendation 1 hybrid financial arrangement mismatch and allow the payer to eliminate the NRWT permanently by treating the payment as a dividend. An alternative would be to reflect the imposition of NRWT by allowing a portion of the payment to be deducted. But this would create further complexity, particularly if the payee country has hybrid rules.

If B Co (the payee) is a reverse hybrid, double non-taxation arises because the interest payment is deductible to C Co (the payer) and not taxable to either B Co or A Co (the investor). Even on distribution by B Co to A Co it may not be taxable, if protected by an exemption for cross border intra-group dividends. The double non-taxation is due to a hybrid mismatch if the payment would have been taxable had it been made directly from C Co to A Co. In this diagram, New Zealand is Country C, and would apply the recommendation 4 counteraction to deny a deduction for the interest payment.

102. OECD recommendation 4 is that countries deny a deduction for a payment to a reverse hybrid if:

- the payment would have been taxed if made directly to the investor (A Co in the case above); and
- the payer, payee and investor are all in a control group or the payment is pursuant to a structured arrangement.

Application to payments to branches

103. In line with the recommendations in the OECD branch mismatch report, we recommend that recommendation 4 also apply to a payment to a control group member which is not taxed to the payee because:

- the payment is a “diverted branch payment”. As defined in the OECD branch report, this is a payment which is treated:
 - in the payee country as attributable to a branch in another country and therefore not taxed
 - in the branch country as not attributable to the branch; and
- the payment is to a “disregarded branch”. As defined in the OECD branch report, a disregarded branch arises when a payment is treated in the payee country as attributable to a branch in another country, but the branch country does not treat the payee as having a branch which would give the branch country a right to tax.

104. We are not aware of such structures being used in New Zealand. However, UK and OECD officials advised us that structures making use of these types of branch mismatches were widely used in Europe, and that the effectiveness of a country’s hybrid measures would be significantly compromised if they were not addressed.

105. Applying the recommendation 4 counteraction to these branch mismatches was accepted in consultation.

Instruments denominated in a foreign currency

106. As for recommendation 1 we recommend that when the payment is on a loan denominated in a foreign currency, the amount of the recommendation 4 denial includes the effect of foreign currency gain or loss.

CFC inclusion

107. As for recommendations 1 and 3 primary rule, we recommend that to the extent that a payment to a reverse hybrid can be proven to give rise to taxation under the owner country's CFC regime, or the CFC regime of a higher tier owner, a deduction should be allowed.

Interaction with non-resident withholding tax

108. As noted in relation to recommendation 1, denial of a deduction under recommendation 4 is permanent, and accordingly the imposition of non-resident withholding tax on the payment will involve a degree of over-taxation. However, because the mismatch does not necessarily arise in relation to hybrid financial instrument (indeed, it may arise on a royalty payment, which is not in relation to a financial instrument at all), there is no basis for recharacterising the payment as a dividend for withholding tax purposes. Accordingly, we do not recommend any adjustment to the imposition of NRWT. This is the approach taken by other jurisdictions. In general the outcome can be avoided by not using reverse hybrid entities.

Interaction with thin capitalisation regime

109. To the extent that a deduction is denied for a payment of interest under recommendation 4, we recommend that the debt corresponding to that deduction, and the payment itself, be treated in the same way as if the deduction were denied under recommendation 1, i.e. it will not be treated as debt for purposes of the rules. .

Reverse hybrids – recommendation 5

110. OECD recommendation 5 is in three parts.

- Recommendation 5.1 suggests countries consider changes to their domestic law so that they tax residents on income which is not taxed in another country due to its being earned by a reverse hybrid;
- Recommendation 5.2 suggests countries consider changes to their domestic law so they tax income which is earned by a reverse hybrid entity established in their country; and
- Recommendation 5.3 suggests countries consider improvements to record keeping and disclosure rules for tax transparent entities established in their country.

111. We propose making changes consistent with recommendation 5.2 and considering further recommendation 5.1. In respect of recommendation 5.3, we believe that New Zealand's record keeping and disclosure rules meet current international standards noting that our rules for foreign trust disclosure have recently been strengthened following the recommendations of the Shewan Report in 2016.

112. However, we note that Australia has indicated that it is unlikely to implement recommendations 5.1 and 5.2 at this point. In respect of recommendation 5.1 this is largely because they see their existing rules as adequate. For recommendation 5.2, we understand that Australia does not see a significant domestic problem that needs to be addressed. By contrast, we consider that the existence of New Zealand limited partnerships and foreign

trusts (discussed below) means it is preferable for New Zealand to follow the OECD recommendations.

Reverse hybrids with a New Zealand investor – recommendation 5.1

113. New Zealand already has a CFC regime which applies to a New Zealand resident holding 10% or more of a foreign company which is controlled by New Zealand residents. Under the CFC regime, such a shareholder is taxed on its share of the foreign company's income of certain kinds, referred to as attributed income. Attributed income includes interest income and certain other passive income, but excludes active income. Accordingly, where a New Zealand resident is an investor in a reverse hybrid, non-taxation by reason of reverse hybridity would only arise in relation to such active income.

114. In consultation, submitters observed that in most cases, active income would already be taxed by the source/establishment country. They therefore questioned the need for any change. However, they accepted that adding to the definition of income subject to attribution under the CFC regime income which is not taxable to the CFC because it is treated by the CFC country of establishment as earned by the New Zealand investor could be the outcome of this project.

115. We note also that there is a de minimis rule in the CFC regime (generally, there is no attribution of income unless potentially attributable income is more than 5% of total income), so attribution will not in most cases be triggered by a relatively small amount of untaxed reverse hybrid income.

116. A rule which taxed CFC income in these circumstances would also apply to a New Zealand resident who uses the attributable FIF income method to calculate FIF income. This method uses the same mechanics as the CFC regime.

117. Although recommendation 5.1 is recommended by the OECD, it is not expected to be adopted by Australia, and it raises some conceptual and practical issues. We would like to consider this matter further and report back.

Reverse hybrids established in New Zealand – recommendation 5.2

118. There are two entities in New Zealand which present a real risk of giving rise to non-taxation as a result of reverse hybridity. They are:

- New Zealand limited partnerships; and
- Trusts with a New Zealand trustee and a foreign settlor or beneficiary.

119. Although a look through company (LTC) may also be a reverse hybrid, the risk of non-taxation is already addressed. A company cannot be an LTC if its foreign income exceeds the greater of \$10,000 or 20% of the company's gross income, if more than 50% of the LTC's shares are held by non-residents.

120. In relation to limited partnerships, we recommend that income which is earned by a limited partnership and attributed to a partner who is not taxable on that income and who is in the same control group as the partnership, should be taxable in New Zealand, on the same

basis as if the non-resident partners were resident in New Zealand. This liability should be on both the limited partner and the general partner (who will have a right of indemnity against the limited partner). We recommend a de minimis at the same level as the LTC de minimis referred to above.

Foreign trusts

121. Foreign trusts have been controversial recently because New Zealand's regime for taxing them is unusual internationally and they have been used as a vehicle for investing offshore by some non-resident settlors and the income was not taxed (nor disclosed) anywhere. This was the topic of the Shewan Inquiry which made recommendations (adopted by the Government) to greatly strengthen disclosure requirements. This addressed the use of foreign trusts to disguise illegal activity, but tax advantages through their hybrid nature remain.

122. We describe below two options for addressing the hybrid mismatch. However, given that the Shewan Inquiry found no conceptual basis to disagree with the fundamental tax treatment of foreign trusts, Ministers could want to retain the current treatment. That said, the frame of reference for the Shewan Inquiry was New Zealand tax principles and international disclosure principles, while the reference for the hybrids mismatch proposals is closing arbitrage options between tax treatments of different countries without inquiring whether any country's treatment is correct from its own domestic perspective.

Hybrid mismatch for beneficiary and trustee income (Inland Revenue recommendation)

123. In relation to foreign trusts a reverse hybrid mismatch can arise in relation to beneficiary income in the same way as it can arise for a limited partnership, if income which is treated for New Zealand tax purposes, and on which the beneficiary would be taxed in its country of residence if it derived the income directly, is not taxed because the residence country regards the income as derived by the trustee. Accordingly, if the beneficiary who is not taxable on beneficiary income due to a reverse hybrid mismatch is in the same control group as the trust, and the trust derives more than the greater of \$10,000 or 20% of its income from foreign sources, we recommend that the beneficiary income be subject to New Zealand taxation, in accordance with recommendation 5.2.

124. A reverse hybrid mismatch can arguably also arise in relation to trustee income. New Zealand does not impose tax on the income of a New Zealand trustee of a foreign trust because of what is often referred to as a settlor approach to trust taxation. We tax foreign source income earned by the foreign trustee of a trust with a New Zealand settlor, on the basis that the income is more appropriately treated as belonging to the settlor (who is a New Zealand resident taxable on worldwide income) than the trustee (who is ordinarily not subject to New Zealand tax on foreign source income). Similarly we do not tax the foreign source income earned by the New Zealand trustee of a trust with a foreign settlor, on the basis that the income is more appropriately treated as earned by the foreign settlor, who is not subject to New Zealand tax on non-New Zealand source income.

125. Since the trustee income of a New Zealand trustee of a foreign trust is taxed as if it were derived by the foreign settlor, there is arguably a hybrid mismatch if the income is not taxed

to the foreign settlor in its residence jurisdiction, and the reason for that non-taxation is that the income has been derived by the New Zealand trustee rather than the settlor directly. Accordingly, if the settlor who is not taxable on trustee income due to a hybrid mismatch is in the same control group as the trust, and the trust derives more than the greater of \$10,000 or 20% of its income from foreign sources, we recommend that the trustee be subject to New Zealand taxation in accordance with recommendation 5.2.

Hybrid mismatch comprehensive foreign trust proposal (Treasury recommendation)

126. New Zealand is relatively unusual in having a settlor regime for trust taxation. As far as we know from research undertaken during the Shewan Inquiry, the settlor basis for trust taxation applies only for settlors resident in New Zealand, Japan, and the United States (for some trusts only) (there could be some other jurisdictions that we are not aware of). This means that there may be many cases where recommendation 5.2 applies.

127. A simpler option would be for New Zealand to tax the New Zealand trustee of all trusts with a New Zealand resident trustee, as well as retaining the settlor regime. This would apply a taxing nexus for trustee income that almost all other countries that recognise trusts apply. It would be a simpler test than having to inquire what the settlor and beneficiary tax regimes are for all trusts with a resident trustee, and would largely pick up the same income.

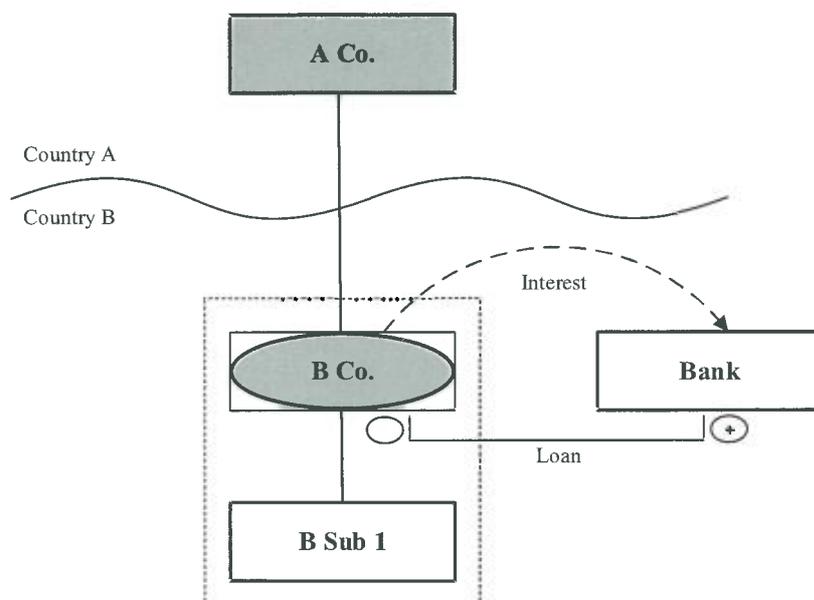
128. Some form of transitional rules may be required in relation to these rules, to deal with events such as trustees who migrate to New Zealand or who become trustees of testamentary trusts. For example, the rules may allow a foreign trustee who migrates and becomes resident in New Zealand up to two years to find a substitute foreign trustee to keep the trust out of the New Zealand tax base. This situation is common internationally for trustees who migrate to another country.

129. In relation to these rules implementing OECD recommendation 5.2, both Inland Revenue and the Treasury recommend that the implementation date be later than for the other measures. Submitters suggested that the private sector may not fully appreciate that trust and partnership structures are within the terms of the hybrid rules. In order to ensure that those affected have adequate time to deal with the proposals, we suggest an implementation date of income years beginning on or after 1 April 2019.

Hybrid entities – double deductions (OECD recommendation 6)

General

130. We recommend that New Zealand introduce rules, in line with OECD recommendation 6, to prevent double non-taxation arising when a hybrid entity makes a payment that is deductible in two countries against non-dual inclusion income. (As discussed elsewhere in this report, this kind of mismatch is currently being used to reduce New Zealand tax, in the Australian limited partnership structures which the Government has already decided to address). A diagram illustrating this possibility follows, where B Co is the hybrid entity.



131. Because A Co treats B Co as fiscally transparent, in Country A the interest paid by B Co is deductible against A Co's other income. In Country B the interest payment is treated as made by a separate company, which is in a tax consolidated group with B Sub 1. Accordingly the interest payment can offset income earned by B Sub 1. This means that each \$1 of interest payment can offset \$2 of income. The outcome is similar to the outcome of a deductible/non-includible mismatch countered by recommendation 3, but in this case it is caused by a payment being deductible in two countries, rather than deductible and disregarded.

132. OECD recommendation 6 is that:

- The investor country (Country A in the diagram) should deny a deduction for the interest payment (the primary rule); and
- If Country A does not do so, then Country B should deny the deduction (the defensive rule).

133. As noted above, Cabinet has already agreed to implement the primary rule (CAB-17-MIN-0164 refers).

134. Recommendation 6 applies to any kind of expenditure, including allowances such as depreciation.

135. As with recommendation 3, denial of a deduction under recommendation 6 should be reversed to the extent that the hybrid entity has dual inclusion income, either in the same period or a later one.

Application to branches

136. The OECD Hybrids Report was explicit that recommendation 6 applies to expenses incurred by a branch if those expenses are deductible in both the branch and parent countries. For many branches, that is not the case, because the legal entity is established in a country (such as Australia) which exempts active branch income. However, expenses incurred by foreign branches of New Zealand companies will be deductible in two countries. Accordingly, this recommendation is particularly relevant to New Zealand companies.

137. The OECD proposes that recommendation 6 apply if there is any potential for expenditure to be offset against non-dual inclusion income, whether or not it is so offset. This could have made foreign branch losses unavailable to be used against New Zealand source income. A blanket denial of deductions for foreign branch losses would not be a comfortable fit with our current policy settings for taxing branch income, and officials have put considerable effort into consultation designed to ensure that recommendation 6 can be implemented in a way that ensures it does not affect the vast majority of New Zealand companies which have foreign branches that are in loss, but are not using the deduction in the branch country against non-dual inclusion income.

Recommendation for scope of recommendation 6 primary rule

138. Officials accordingly recommend that the primary rule in recommendation 6 apply to expenditure of a foreign branch/hybrid entity with a New Zealand parent/investor only where there is another entity with income that is not taxable in New Zealand but able to be offset in any way by any branch/hybrid entity loss (including where such offset requires an election or other similar step having tax significance only).

139. This restriction means that a New Zealand company with a foreign branch would in most circumstances not be denied a deduction in New Zealand for any branch/hybrid loss under recommendation 6. There would be no denial, for instance, in the case of a New Zealand company with one or more Australian branches if:

- the New Zealand group does not own any other Australian entities; or
- if it does own other Australian entities, those entities' income cannot be offset by any branch loss. We understand that in Australia a loss incurred by an Australian branch of a non-resident company cannot offset income earned by a resident company. On that basis, ownership of an Australian company by the New Zealand group also would be consistent with the non-application of recommendation 6 primary rule.

140. The restriction explained above was generally accepted in consultation, and officials believe that it produces a sensible policy outcome. It does not go so far as denying the branch/hybrid loss only to the extent it is used against non-dual inclusion income. Consultation established that such a rule, though also potentially producing an appropriate outcome, would be much more complex to design and administer.

Recommendation for transitional situations

141. This recommendation means that a rule is required to deal with the situation where a New Zealand resident with a loss-making foreign branch or hybrid at some point becomes subject to recommendation 6 primary rule by virtue of acquiring an interest in an entity in the branch country whose income is not taxable in New Zealand but can be offset by the branch losses. Officials recommend that:

- if the branch loss arising before the acquisition of the interest in the second entity cannot be offset against the new entity's income (as will often be the case, including we understand in Australia), then the only consequence is that subsequent branch losses are subject to the recommendation 6 primary rule; and

- otherwise, all losses of the branch which have been used against New Zealand income should be recaptured, since they are now available to be used against non-dual inclusion income.

142. Officials do not believe this rule will often apply, but it is important for the integrity of the hybrids package.

143. We also recommend a similar rule to operate in favour of a New Zealand resident with a hybrid entity or branch which has been subject to loss denial under recommendation 6. If it becomes impossible for the loss to be used in the branch/hybrid jurisdiction, then it should be allowed in New Zealand. This could occur if, for example, the hybrid is wound up in the foreign country, or if the entity with non-dual inclusion income is sold. In that case the suspended losses would be deductible in New Zealand to the extent of the carried forward loss, as calculated under the rules of the hybrid or branch country, that has become unusable in that country.

Simple implementation solution

144. As with recommendation 3, in order to simplify compliance, we recommend that the amount of double deductible expenditure and dual inclusion income be the amount calculated under New Zealand tax principles, without close regard to whether such amounts match the amounts which are deductible or taxable in the other country. This possibility is referred to in the OECD final report and was strongly supported in consultation.

145. As with recommendation 3 defensive rule, we recommend that when New Zealand is applying the primary rule, income protected from tax by a foreign tax credit would not be dual inclusion income.

CFC taxation in investor country can give rise to dual inclusion income

146. We recommend that income which can be shown to be taxable both in the branch/hybrid country and under CFC rules in the investor country should be able to be treated as dual inclusion income. Again this would not be the case if the CFC taxation is reduced by a credit for tax paid in the branch/hybrid country.

Effect of deferred deduction on foreign tax credit limitation

147. Deductions deferred under recommendation 6 will under existing law reduce the foreign tax credit limitation in the year the deductions are allowed. No change is required.

Effect of loss of ownership continuity on carry forwards

148. As for OECD recommendation 3, we recommend that if a taxpayer subject to recommendation 6 denial is a company and there is a 51% or greater change in its ownership after the time when the deduction would ordinarily be claimed, the deductions would not be able to be claimed in the future.

Interaction with NRWT

149. In relation to the new rules imposing NRWT on an accrual basis, we recommend a similar modification to that recommended for OECD recommendation 3.

Interaction with thin capitalisation

150. We make the same recommendation as for OECD recommendation 3.

Opaque election

151. In consultation, there has been a strong submission that a New Zealand owner of a foreign hybrid entity should be permitted to treat the hybrid as a company, in line with its foreign treatment. Recommendation 6 would then no longer apply to it. This submission was based on a desire for simplicity.

152. Officials understand the reasons for the submission. However we are concerned that it might lead to significant administrative and legislative complexity, for what might be a small handful of taxpayers. Accordingly, we recommend that we consider further whether it is possible to design a tightly targeted and simple opaque election, with a view to reporting back on our recommendations before the proposed bill is finalised.

Dual resident entities (OECD recommendation 7)

General

153. OECD recommendation 7 is that countries should deny a deduction to dual resident companies except to the extent of dual inclusion income. We recommend that New Zealand amend its existing rules relating to losses incurred by dual resident companies, to ensure they are fully effective to prevent deductions being taken against non-dual inclusion income.

154. Dual resident companies give rise to the same double deduction possibilities as hybrid entities. Expenditure incurred by such a company may be able to be used in each residence country to offset non-dual inclusion income, i.e. income taxed only in that country.

155. New Zealand's rules already prevent dual resident companies from grouping their losses or forming part of a tax consolidated group. However, it does not prevent them offsetting expenditure against non-dual inclusion income earned through a reverse hybrid, such as (in many instances) a New Zealand limited liability partnership.

156. Submitters made the point that dual residence can arise inadvertently. For example, a corporate group in New Zealand may incorporate a subsidiary in Australia (which would therefore be an Australian tax resident company) but exercise sufficient director control in New Zealand that the company is arguably also New Zealand tax resident. Officials observe that if this is indeed a problem, it is a problem under the existing rules denying dual resident companies the ability to group losses, be part of a tax consolidated group, or even maintain an imputation credit account.

Similar rules to that applying to changes implementing OECD recommendation 6

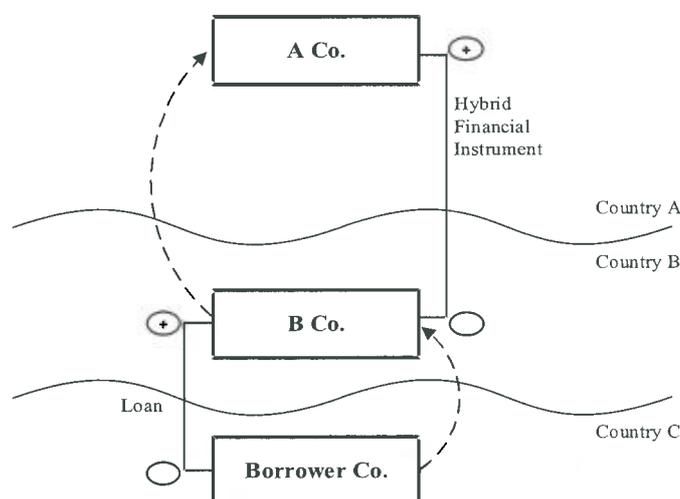
157. The following recommendations made in relation to OECD recommendation 6 also apply in relation to recommendation 7:

- simple implementation solution;
- the effect of deferred deductions on the foreign tax credit limitation;
- the effect of loss of ownership continuity on carry forwards; and
- interact with thin capitalisation.

Imported mismatches (OECD recommendation 8)

General

158. We recommend that New Zealand introduce rules in line with OECD recommendation 8 to deny a deduction for a payment between members of a control group that funds a payment under a hybrid mismatch, including a branch mismatch. This is referred to as an imported mismatch rule. An example follows.



159. The interest payment by Borrower Co to B Co does not in isolation give rise to a hybrid mismatch. The loan is treated the same way in both Country B and Country C (which could be New Zealand). However, B Co makes payments to A Co under a hybrid financial instrument. The tax mismatch is not counteracted, because neither country has hybrid rules. If Country C makes no hybrid counteraction in such a case, the hybrid rules are ineffective to deal with arrangements between Country A and Country C. Businesses can avoid the rules simply by going from A to C via B.

160. In order to prevent its hybrid rules being circumvented, Country C can treat the loan from B Co to Borrower Co as an imported mismatch arrangement, and deny a deduction for the interest payments by Borrower Co to the extent that they do not exceed the payments under the hybrid financial instrument between B Co and A Co.

161. The OECD imported hybrid mismatch rule applies to both structured and unstructured imported mismatches.

- A structured imported mismatch arises when a deductible payment is part of a structured arrangement involving a hybrid mismatch – for example if the funding chain the above diagram was entered into deliberately, in order to move money from

A Co to Borrower Co. A structured imported mismatch rule prevents a country's hybrid mismatch rules being deliberately circumvented.

- An unstructured imported mismatch arises when there is no such intention. There is simply a deductible payment by a person resident in a country with hybrid rules, where the payee in turn makes a deductible payment under a hybrid mismatch arrangement (which may itself be an imported mismatch arrangement). The unstructured imported mismatch rule is intended to extend the reach of the hybrid rules, rather than to prevent their deliberate circumvention.

162. The OECD proposes complex apportionment rules which may need to be applied to determine the amount of denial in an unstructured hybrid mismatch.

163. The imported mismatch rule will not need to be applied in respect of payments to a person in a country with the hybrid rules. The payee's country can be relied on to address any hybrid mismatches in that case. Furthermore, as more countries adopt hybrid rules, there should be fewer hybrids and hybrid mismatches in existence, and so less need for the imported hybrid rule to apply.

164. Those we consulted were not generally in favour of countering imported mismatches, on the basis that the hybrid mismatch was not directly with New Zealand. That said, they generally understood the need for a structured imported mismatch rule, but were concerned about the complexity and uncertainty around the unstructured rule. We recommend that this concern be addressed by deferring the application date for the unstructured imported mismatch rule. This recommendation is discussed in more detail under the heading *Effective date*.

Foreign currency instruments

165. When an imported mismatch payment is a return on a foreign currency loan, the issue of how to deal with foreign currency fluctuations arises as it does for the other recommendations. In this case we recommend that the foreign currency is not taken into account. The basis for the counteraction is that the New Zealand payment is funding in some way a hybrid mismatch payment by another entity. The extent of this funding may differ from year to year. Thus it is best measured by reference to the amount of the coupon payment alone, rather than including as well any foreign currency movements, which will generally have no cash flow impact in the relevant year.

Interaction with non-resident withholding tax

166. We do not recommend adjusting any non-resident withholding tax on a payment for which a deduction is denied under the imported mismatch rule. Because the payment will be treated as ordinary income in the payee country, any withholding tax will generally give rise to a tax credit in the payee country.

167. As with the other mismatch denial rules, we recommend that deductions disallowed under the imported mismatch rule not be taken into account when deciding whether or not to apply the anti-NRWT-deferral rule.

Interaction with thin capitalisation regime

168. As with a recommendation 1 (non-timing) and recommendation 4 denial, to the extent that interest on a financial arrangement is subject to denial under the imported mismatch rule we recommend that it not be treated for purposes of the thin capitalisation regime as debt.

Co-ordination rule

169. We recommend that the hybrid legislation includes a rule to deal with the situation where a hybrid mismatch arrangement which is subject to counteraction in one country (say New Zealand) ceases to be so subject, for example because the other country introduces hybrid rules, and is responsible applying taking the primary response. We recommend that this rule be consistent with the approach taken to this issue in the OECD Final Report. We did not receive any submissions against this approach.

Definitions

170. The hybrid rules may require some new definitions to be added to the Income Tax Act, and the amendment of some existing definitions. In particular, a definition will be required of a structured arrangement, and the importance of this was stressed in submissions. We did not receive any submissions against the definitional approach proposed in the discussion document, and recommend that we approach the task of drafting supporting definitions in line with what was proposed there.

Specific anti-avoidance rule

171. We recommend that the hybrid rules include a specific anti-avoidance rule, allowing the Commissioner to counteract arrangements having a purpose or effect of defeating the intent or application of the hybrid rules.

Effective date, transitional and grandparenting

172. Cabinet has already agreed that OECD recommendation 6 primary rule should apply to New Zealand residents for income years beginning on or after 1 July 2018 (CAB-17-MIN-0164 refers). This is on the basis that a bill is introduced to Parliament before the end of 2017, and in force before 1 July 2018. We recommend the same start date for all of the hybrid recommendations in this report other than that relating to unstructured imported mismatches and reverse hybrids, discussed below.

173. This may be:

- a similar timetable to that in the UK (where the effective date was 8 months after introduction of the legislation into Parliament); and
- shorter than that proposed in Australia, which has announced that its effective date will be at least six months after its legislation is enacted.

174. In general, we do not see any need for a longer lead time than that we propose. The target and effect of the hybrid rules is has been identified with some specificity, and has not changed in any significant way (other, perhaps, than the addition of branch mismatches

beyond those in recommendation 6). Parties should be able to plan their affairs already with a high degree of confidence as to what the effect of the rules will be.

175. In relation to unstructured imported mismatches:

- there is still considerable uncertainty as to how this rule should apply, given that it requires a co-ordinated counteraction of mismatches that may themselves be difficult to find and to quantify;
- there will be less need to apply the rule as the hybrid rules are enacted in more countries. The unstructured imported mismatch rule does not apply to payments to a country with hybrid rules, and the adoption of the rule by more countries will reduce the number of hybrids in any event;
- the adoption of the rules by more countries may assist in developing an understanding of how the unstructured imported mismatch rule should apply; and
- the rule is more about extending the reach of the hybrid rules than ensuring their integrity.

176. The UK has introduced hybrid rules including an unstructured imported mismatch rule effective 1 January 2017. Australia has not made any announcement. The EU directive includes an unstructured imported mismatch rule which must be effective from 1 January 2020.

177. We recommend that the effective date of the unstructured imported mismatch rule be delayed until 1 January 2020. By that time, all of the EU member states are expected to have hybrid rules, and so the application of the unstructured imported rule will be both less frequent and, we expect, better developed. We do not make the same recommendation for the structured imported mismatch rule, as that would create an integrity issue for the rules.

178. We also recommend a delayed implementation date for the recommendations relating to limited partnerships and foreign trusts which are reverse hybrids. As discussed above, the private sector may not fully appreciate that trust and partnership structures are within the terms of the hybrid rules. In order to ensure that those affected have adequate time to deal with the proposals, we suggest an implementation date of income years beginning on or after 1 April 2019.

Transitional and grandparenting

179. All of the OECD Final Report, the Australian Board of Taxation report, and our discussion document, do not recommend any general transitional relief for existing arrangements. The hybrid rules generally apply to transactions between parties at least 25% commonly owned, or deliberately structured arrangements. They produce tax benefits that generally were not intended, but flow from the unintended interaction of different countries' rules. The effect of the rules will be to remove inappropriate benefits. They will not have a punitive effect (except in relation to the imposition of NRWT), and except to the extent that they do, no exception can reasonably be taken to their application to existing transactions.

180. The absence of transitional relief is the same approach as was taken, without adverse reaction, to certain related party NRWT minimisation structures in the recently enacted Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act

181. We recommend no transitional relief from the hybrid rules, subject to an exception for certain capital issued by banks (and insurance companies – for purposes of discussion we refer only to banks, but similar rules apply to both), as discussed further below.

182. A number of banks operating in New Zealand have issued debt instruments which are both:

- hybrid mismatch arrangements (or imported hybrid mismatch arrangements), in the sense that the return on the instruments is deductible in New Zealand but treated as a dividend in Australia or elsewhere; and
- regulatory capital for capital adequacy purposes, either in New Zealand or Australia.

183. Many of these issues have been made directly to the public in Australia. In some cases the instruments have been issued to a foreign branch of the New Zealand bank's foreign parent. Most of them are able to be repaid by the issuer after 5 years.

184. The fact that these instruments raise regulatory capital does not in our view justify any grandfathering. In discussions with the Reserve Bank, they have told us that there is no particular benefit in these instruments from a regulatory perspective, and that they would be comfortable with the banks replacing these instruments with ordinary shares to the extent that the capital they raise is required for regulatory purposes. Accordingly, in our discussion document we did not recommend any special treatment for these instruments.

185. However, these instruments do differ from most hybrids insofar as they are held by third party investors, often retail rather than wholesale (the hybrid rules apply to them because they are structured, rather than related party). This in turn means that if the hybrid rules were to apply to them so as to:

- impose additional tax on the investors, the investors may have a right to be indemnified by the bank (this would be the case if recommendation 2, or recommendation 1 defensive rule applied to the investors); or
- increase the after-tax cost of the funding to the issuer (which might be the result if any of the rules applied), the issuer may have a right to terminate the investment early.

186. The banks have submitted that subjecting regulatory capital to the hybrid regime with no grandparenting would be inappropriate because:

- restructuring such capital would require regulatory approval, possibly from more than one regulator; and
- such restructuring might be disruptive to the financial markets in which bank capital is raised, especially if all the banks were looking to replace their existing issuances at the same time.

187. Different banks made different submissions on the date from which grandparenting should cease to apply, ranging from the date of release of the OECD Final Report (October 2015), through the date of release of the Government discussion document (6 September 2016) to the date of enactment of New Zealand's hybrid legislation. Co-ordination with Australia was also encouraged. In this respect we note that Australia announced in its 2017 Budget that it will:

- apply recommendation 2 to dividends on hybrid regulatory capital, thus denying the payee the benefit of an imputation (or franking) credit; and
- grandparent instruments issued before 8 May 2017.

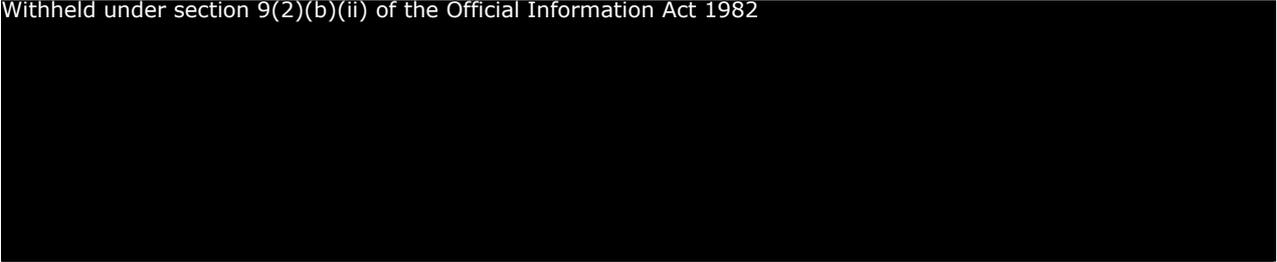
188. There are some grounds for treating the publicly issued instruments differently from most hybrid instruments. Australia's decision to grandparent also puts a heavy burden of proof on New Zealand to justify a decision to do otherwise. Accordingly we recommend providing some grandparenting. The issues then are:

- which transactions should be grandparented; and
- from what date.

189. As to the first of these, we recommend that only transactions which are directly to the public, or which are traceable to an issue to the public, should be grandparented. However, we have not yet had the opportunity to discuss this in detail with the banks, and may refine or expand this core recommendation as we do so.

190. As to the date, we recommend that grandparenting apply only to transactions entered into before the release of our discussion document on 6 September 2016. That document announced the Government's intention to enact hybrid rules with no regulatory capital exception. It was also a date that was indicated as acceptable in some written submissions, and in consultation.

Withheld under section 9(2)(b)(ii) of the Official Information Act 1982



APPENDIX 1: OVERVIEW OF OECD RECOMMENDATIONS

Linking rule recommendations:

| <i>Rec.</i> | <i>Hybrid mismatch</i> | <i>Hybrid arrangement</i> | <i>Corresponding branch arrangement</i> | <i>Counteraction</i> | <i>Scope</i> |
|-------------|--------------------------------|---|--|---|---|
| 1 | D/NI (deduction/ no inclusion) | Hybrid financial instruments (includes timing) | | Primary: deny deduction for payment Defensive: include payment in income | Related parties (25%) or structured arrangements |
| 3 | D/NI | Disregarded payments | Deemed branch payments | Primary: deny deduction for payment to the extent expenditure exceeds DII Defensive: include payment in income to the extent exceeds DII | Control group (generally 50%) or structured arrangements |
| 4 | D/NI | Reverse hybrids – linking rule | Disregarded branch structure and diverted branch payments | Primary: deny deduction Defensive: None (Recommendation 5 acts as a defensive rule) | Control group or structured arrangements |
| 6 | DD (double deduction) | Double deductions (including those arising by virtue of a foreign branch) | (Recommendation 6 already applies to double deduction branch outcomes) | Primary: parent/head office country denies deduction to the extent exceeds DII Defensive: subsidiary/branch country denies deduction to the extent exceeds DII | No limit for primary rule. Defensive rule limited to control group or structured arrangements |
| 7 | DD | Payments by dual resident company | | Deny deduction in both jurisdictions to the extent exceeds DII | No limit |
| 8 | Indirect D/NI | Imported mismatches | Imported branch mismatches | Primary: deny deduction for payment to the extent it funds the hybrid or branch mismatch payment Defensive: None | Control group or structured arrangements. Does not apply if payee subject to hybrid rules |

Specific rule recommendations:

| <i>Rec.</i> | <i>Hybrid mismatch</i> | <i>Hybrid arrangement</i> | <i>Corresponding branch arrangement</i> | <i>Counteraction</i> | <i>Scope</i> |
|-------------|------------------------|---|---|---|---|
| 2 | D/NI | Hybrid financial instruments – specific rules | | 2.1 Payee country should turn off any exemption 2.2 Restrict FTCs to hybrid arrangement | No limit |
| 5 | D/NI | Reverse hybrids – specific rules | Disregarded branch structure and diverted branch payments | 5.1 Improve CFC and other offshore rules 5.2 Turn off transparency/non-taxation 5.3 Improved disclosure | Specific to individual country's domestic law |

APPENDIX 2: GLOSSARY

| | |
|---|--|
| CFC rules | New Zealand has a controlled foreign companies (CFC) regime that attributes the passive income of CFCs to New Zealand owners. New Zealand's CFC rules are an important part of our international tax rules and are generally considered to be robust. |
| Deduction/ no inclusion (D/NI) | A hybrid result where a member of a group can claim a deduction for an intra-group payment and that deduction is not balanced by income inclusion for the recipient. |
| Double deductions (DD) | A hybrid result where a group can claim tax deductions against two different amounts of income for one item of expenditure. |
| FIF rules <ul style="list-style-type: none"> • fair dividend rate • cost • deemed rate of return • comparative value method • attributed FIF income method | New Zealand has a foreign investment fund (FIF) regime which seeks to tax New Zealand residents on their portfolio income from foreign share investment in a practical way. There are a number of methods to calculate FIF income, including: <ul style="list-style-type: none"> • The fair dividend rate (FDR) and cost methods which approximates total annual return as 5% of an investor's holding and taxes on that basis; • The deemed rate of return (DRR) method which approximates total annual return as a rate set by Order in Council each year; and • The comparative value (CV) method which measures change in value across the relevant year plus any other gain such as a dividend and taxes that amount. • The attributed FIF income method, which taxes the resident on a share of the underlying income of the |
| Foreign branch | A New Zealand company that operates in a foreign country through a permanent establishment in that country. Because New Zealand taxes the worldwide income of its residents, a New Zealand company with a foreign branch operation that is in loss has the potential to create a hybrid outcome as the loss can be used against New Zealand as well as (potentially) offshore income which New Zealand does not tax. |
| Foreign tax credit | New Zealand's tax law allows its residents to claim a foreign tax credit for tax paid overseas on a segment of foreign-sourced income. If that income is taxable in New Zealand, residents can claim the foreign tax credit against New Zealand tax to prevent double taxation. |
| Hybrid entities | An entity that is treated for tax purposes as transparent or disregarded (its income and expenditure is attributed to its owners or (in the case of payments to an owner) ignored) in the jurisdiction of its parent/investor and opaque (it is taxed as a separate entity on its income and expenditure) in the jurisdiction it is established in. This type of entity can produce double deductions and deduction/no inclusion outcomes. |
| Hybrid financial instrument (permanent) | A financial arrangement between two parties (e.g. a convertible note) that is regarded as debt in one country and equity in another. The effect of this misalignment in characterisation is that payments under the arrangement are treated as tax deductible interest to the payer and (generally) tax exempt dividends for the |

| | |
|-----------------------------------|---|
| | recipient. |
| Reverse hybrid entity | The reverse of a hybrid entity; an entity that is treated for tax purposes as transparent in its establishment jurisdiction and as opaque in the jurisdiction of its parent/investor. This type of entity has the potential to create a double non-taxation result. |
| Share lending | A transaction where the owner of a share lends that share to another person. Typically the share borrower will transfer collateral to the lender and will pay the share lender a replacement or substitute payment for any dividends rpaid on the shares during the term of the share lending arrangement (which is often very short) if applicable. Share lending has the potential to fall within the hybrid mismatch rules if the arrangement is between related parties or is a structured arrangement, is cross-border, and the two jurisdictions involved take inconsistent views of the substitute payment. Share repos are similar transactions and can produce similar results. |
| Share repo | Similar to share lending, but this time the shares are provided as collateral for a loan from the share borrower to the share lender. A share repo differs from secured lending because the money lender can sell the shares during the term of the loan, remaining subject of course to an obligation to redeliver them. |
| Tax consolidation / loss grouping | Tax consolidation refers to the ability of related party entities to consolidate their tax returns. This can have the effect of enabling hybrid outcomes, as hybrid losses (double deductions and unbalanced deductions) can be consolidated with the ordinary income of a related entity. Similarly, loss grouping rules allow a hybrid loss to be transferred into a related party entity that is in profit, thus reducing their taxable income. |