

August 2018

*A special report from*  
Policy and Strategy, Inland Revenue

---

## Hybrid and branch mismatch rules

---

*Sections FH 1 to FH 15, EX 44(2), EX 46(6)(e), EX 46 (10)(db), EX 47B, EX 52(14C), EX 53(16C), RF 2C, FE 6(2), FE 66(3)(a), FE 6(3)(aba), FE 15(1)(a), BH 1(4) and RF 11C of the Income Tax Act 2007*

Hybrid and branch mismatch arrangements are cross-border arrangements that exploit differences in the tax treatment of an instrument, entity or branch under the laws of two or more countries to eliminate, defer or reduce income tax. This is often referred to as double non-taxation.

The OECD as part of Action 2 of its BEPS Action Plan has made a number of recommendations for domestic law changes to help countries neutralise the tax advantages from hybrid and branch mismatches. These recommendations have been picked up (or are being picked) by a number of countries including the United Kingdom, Australia, the members of the European Union and (to a more limited extent) the United States.

Subpart FH of the Income Tax Act 2007 enacts the core aspects of the OECD recommendations with suitable modification for the New Zealand context. There are consequential amendments to other tax regimes including the FIF (foreign investment fund), NRWT (non-resident withholding tax) and thin capitalisation rules.

### Background

Hybrid and branch mismatch arrangements exploit the different ways that countries treat financial instruments (hybrid instruments) and entities (hybrid entities and branches) to create tax advantages.

Take the simple example of a hybrid financial instrument issued by a subsidiary to its parent company (resident in another country) that makes a quarterly coupon payment. The instrument is treated as debt by the subsidiary and the coupons result in deductible interest. The instrument is treated as equity by the parent and the coupons are treated as non-assessable dividend income. The hybrid financial instrument results in double non-taxation as there is a deduction in the subsidiary country for an amount that is not taxed in the parent country.

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, causes distortions in investment patterns, results in an unintended reduction in aggregate tax revenues, and generally gives multinationals an unfair competitive advantage over local businesses.

To counter such double non-taxation, the OECD made a number of recommendations to address hybrid and branch mismatches through the release of two reports in 2015 and 2017.<sup>1</sup> The recommendations comprise two kinds of rules.

The first kind are rules to reduce the likelihood of such mismatches arising. For example, the OECD recommended that countries include a rule so that a foreign dividend exemption in the payee country is not available to the extent the dividend payment is deductible to the payer. New Zealand already has such a rule in section CW 9.

The second kind are “linking rules” which apply where the mismatch has not been prevented by other domestic rules. The linking rules effectively adjust the tax outcomes under a hybrid or branch mismatch in one country in order to align them with the tax outcomes in the other country.

Consistent with the approach adopted by several countries around the world, New Zealand has chosen to adopt the OECD recommendations in a comprehensive manner with suitable modification for the New Zealand context. The linking rules are introduced through subpart FH and there are consequential amendments to other tax regimes as well, including the FIF, NRWT and thin capitalisation rules.

While the new rules are relatively complex, it is important to bear in mind that they will have no impact for the vast majority of taxpayers. Their impact will be limited to taxpayers that are currently benefitting from tax arbitrage because of hybrid or branch mismatches.

## **Key features**

Subpart FH includes rules to address the hybrid and branch mismatches arising from the following:

- hybrid financial instruments (sections FH 3 and 4);
- disregarded hybrid payments and deemed branch payments (sections FH 5 and 6);
- reverse hybrids and branch payee mismatches (section FH 7);
- deductible hybrid and branch payments resulting in double deductions (sections FH 8 and 9);
- dual resident payers (section FH 10); and
- imported mismatches (section FH 11).

Where there are two or more parties to a mismatch, the rules generally only apply if there is some degree of association between the parties to the arrangement, or if the arrangement has been structured to achieve a mismatch.

Subpart FH provides some ways for taxpayers to simplify the application of the hybrid and branch mismatch rules to their arrangements. In particular, in respect of:

---

<sup>1</sup> *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (2015)* and *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (2017)*.

- inbound hybrid financial instruments, the taxpayer may elect to treat the instrument as a share for New Zealand income tax purposes (section FH 13); and
- wholly-owned outbound foreign hybrid entities existing on 6 December 2017 (the date the Taxation (Neutralising Base Erosion and Profit Shifting) Bill was introduced), the taxpayer may irrevocably elect to treat the entity as a company for New Zealand income tax purposes (section FH 14).

The introduction of the linking rules in subpart FH of the Act has flow on implications for other New Zealand tax regimes, including the FIF, NRWT and thin capitalisation rules.

### **Application dates**

The majority of the hybrid and branch mismatch rules apply for income years beginning on or after 1 July 2018. There are two exceptions to this application date.

The first exception is in respect of the financial instrument rule in sections FH 3 and FH 4 for banking or insurance regulatory capital instruments issued on or before 6 September 2016 (the date the Government discussion document on *Addressing hybrid mismatch arrangements* was released). This regulatory capital has been grand-parented until the first date on which the person has an unconditional right to call or otherwise cancel the financial instrument without penalty.

The second exception is in respect of the imported mismatch rule in section FH 11 for non-structured imported mismatches. For payments under non-structured imported mismatches, the rule will apply for income years beginning on or after 1 January 2020.

## CORE PRINCIPLES AND CONCEPTS

---

### *Sections FH 1 and FH 2*

The hybrid and branch mismatch rules introduce a number of new concepts to tax legislation. This section of the special report highlights a number of the key concepts and principles before considering the specific hybrid and branch mismatch rules introduced in subpart FH and the consequential amendments from those rules.

For simplicity, the rules will generally be referred to interchangeably as the “hybrid and branch mismatch rules” and the “hybrid rules” in this special report. This is consistent with the definition of “hybrid mismatch legislation” in section FH 15 which covers both the hybrid and branch mismatch rules.

### **OECD hybrid and branch mismatch reports**

The OECD as part of Action 2 of its BEPS Action Plan has made a number of recommendations to help countries change their domestic law so as to neutralise the tax advantages from hybrid and branch mismatches through two reports issued in 2015 and 2017.<sup>2</sup>

The hybrid mismatch report outlined comprehensive recommendations to deal with hybrid mismatch arrangements in October 2015. This report considered mismatches that are the result of differences in the tax treatment or characterisation of an instrument or entity. While some of the hybrid mismatches identified in the report involved branches, it did not directly consider similar issues that can arise through the use of branch structures.

The branch mismatch report considering these issues was issued in 2017. The report considered mismatches that arise as a result of differences in the allocation of income and expenditure between a branch and head office, including situations where the branch country does not treat the taxpayer as having a taxable presence in that country.

The hybrid and branch mismatch rules introduced in subpart FH closely follow the OECD recommendations with suitable modification for the New Zealand context. While the terminology used in the OECD hybrid and branch reports and the legislation is not necessarily the same, the intent is broadly similar and some of the examples in the special report have been adapted from the OECD reports. Therefore, in addition to the guidance in this special report, the OECD hybrid and branch mismatch reports may generally be used as interpretive aids for the hybrid and branch mismatch rules.

### **Hybrid and branch mismatch arrangements**

Hybrid and branch mismatch arrangements are cross-border arrangements that exploit differences in the tax treatment of an instrument, entity or branch under the laws of two or

---

<sup>2</sup> *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (2015)* and *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (2017)*.

more countries to defer or reduce income tax. This can result in double non-taxation, including long term tax deferral.

### **D/NI and DD mismatches**

There are two broad types of hybrid and branch mismatch arrangements addressed in the OECD hybrid and branch mismatch reports: deduction/non-inclusion (D/NI) arrangements and double deduction (DD) arrangements.

D/NI mismatch arrangements occur when a payment results in a deduction in one country with no corresponding income taxed in the recipient country, if that outcome is the result of the different tax treatment of an instrument, entity or branch.

DD mismatch arrangements occur when a taxpayer is entitled to a deduction in two countries for the same payment.

D/NI and DD hybrid and branch mismatches can arise in several ways involving financial instruments, hybrid entities or branches. The OECD identified a number of ways in which the mismatches can arise and developed recommendations to neutralise the tax advantages they can provide in the reports noted above. These ways include mismatches that arise through the use of hybrid financial instruments, disregarded hybrid payments, structures producing double deductions, reverse hybrids, dual resident entities, imported mismatches, and deemed branch payments and payee mismatches. Each of these hybrid or branch mismatch arrangements is covered by the rules in subpart FH and discussed in detail later in the special report.

### **OECD recommendations**

The OECD recommended two kinds of rules to address hybrid and branch mismatches. The first kind are rules to reduce the likelihood of such mismatches arising. For example, the OECD recommended that jurisdictions include a rule so that a foreign dividend exemption in the payee country is not available to the extent the dividend payment is deductible to the payer. New Zealand already has a rule to cover this circumstance in section CW 9.

The second are “linking rules” which apply where the mismatch has not been prevented by any other domestic rules. The linking rules effectively adjust the tax outcomes under a hybrid or branch mismatch in one country in order to align them with the tax outcomes in the other country. Since both countries may have a provision to adjust the tax outcomes under a particular hybrid or branch mismatch arrangement, in a number of cases, there is an order of application through “primary” and “defensive” rules. This ensures that, in situations where both countries have implemented hybrid and branch mismatch rules that would counter a particular arrangement, only one country will counter the mismatch.

The primary rule is broadly that the payer country should deny a deduction to the extent it is:

- not included in the taxable income of the recipient country (for a D/NI mismatch); and
- claimed with respect to expenditure of a resident that is also deductible in another country (for a DD mismatch).

If the primary rule is not applied because the payer country has not implemented the hybrid and branch mismatch rules, then the defensive rule can apply:

- requiring the deductible payment to be included in taxable income of the recipient (for a D/NI mismatch); or
- denying the deduction in the country where the payment is made (for a DD mismatch).

Table 1 summarises how the OECD recommendations have been implemented into domestic law. The recommendations are numbered in accordance with the OECD hybrid mismatch report with the corresponding branch mismatch recommendation (if any) showed separately alongside the hybrid recommendations.

### **Restructuring considerations**

The intended outcome of the introduction of hybrid and branch mismatch rules is that less hybrid and branch mismatch arrangements will be used by taxpayers. Generally, if a taxpayer chooses an ordinary arrangement or structure over one that exploits a mismatch the tax advantage will be removed. Even if this does not result in additional tax revenue for the New Zealand Government, this is a desirable outcome. Taxpayers should be able to restructure out of hybrid and branch mismatch arrangements into ordinary structures without attracting tax avoidance risks.

Take the example of a foreign company (resident in a country without hybrid rules) that funds a New Zealand subsidiary company with the use of a hybrid financial instrument. Interest paid by the New Zealand subsidiary under the instrument would be subject to deduction denial under section FH 3 of the hybrid rules (see below for discussion of this rule). The foreign company decides to refinance its New Zealand investment in response to the introduction of New Zealand hybrid rules. The replacement financing might be an ordinary debt arrangement under which the New Zealand subsidiary would pay interest not subject to deduction denial under FH 3, and taxable in the foreign country. This type of refinancing should not be considered tax avoidance despite the possibility that a valid deduction could have replaced a denied deduction, thereby reducing New Zealand taxable income.

Similarly, a foreign company that owns a hybrid entity in New Zealand (such as an unlimited liability company) may wish to restructure its New Zealand operations in response to the introduction of New Zealand hybrid rules. A replacement structure may be a limited liability company with expenditure that is not subject to deduction denial under sections FH 5 and FH 9 (see below for discussion of these rules). This type of restructure should not be considered tax avoidance even if denied deductions of a hybrid entity in New Zealand would be replaced by valid deductions that are not part of a hybrid mismatch arrangement.

**Table 1: New Zealand's implementation of the OECD recommendations**

**Linking rule recommendations**

Section	Rec.	Hybrid mismatch	Hybrid arrangement	Corresponding branch arrangement	Counteraction	Scope
FH 3 and 4	1	D/NI (deduction/ no inclusion)	Hybrid financial instruments (includes timing)		Primary: deny deduction for payment Defensive: include payment in income	Related parties (generally twenty five percent) or structured arrangements
FH 5 and 6	3	D/NI	Disregarded payments	Deemed branch payments	Primary: deny deduction for payment to the extent expenditure exceeds DII/SAI* Defensive: include payment in income to the extent exceeds DII/SAI*	Control group (generally fifty percent) or structured arrangements
FH 7	4	D/NI	Reverse hybrids – linking rule	Disregarded branch structure and diverted branch payments	Primary: deny deduction Defensive: None	Control group or structured arrangements
FH 8 and 9	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/SAI* Defensive: subsidiary/branch country denies deduction to the extent exceeds DII/SAI*	Primary rule limited to related parties (generally twenty five percent) Defensive rule limited to control group (generally fifty percent)
FH 10	7	DD	Payments by dual resident company		Deny deduction in both jurisdictions to the extent exceeds DII/SAI	No limit
FH 11	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**

Section	Rec.	Hybrid mismatch	Hybrid arrangement	Corresponding branch arrangement	Counteraction	Scope
CW 9	2	D/NI	Hybrid financial instruments – specific rules**		2.1 Payee country should turn off any exemption 2.2 Restrict foreign tax credits to hybrid arrangement	No limit
Subpart EX	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 NZ' s domestic law

\* Surplus assessable income (SAI) performs the same function as dual inclusion income (DII) in the hybrid mismatch report.

\*\* There have been no legislative changes for recommendation 2. Section CW 9 addresses recommendation 2.1.

\*\*\* There have been no legislative changes for recommendation 5.

## Scope of the linking rules

Where there are two or more parties to a mismatch, the rules generally only apply if there is some degree of association between the relevant parties to the arrangement, or if the arrangement has been structured to achieve a mismatch.

There are four key definitions that determine whether the rules potentially apply: “act together”, “control group”, “related” and “structured arrangement”. We discuss these terms individually in the following section on key definitions.

## Ordering of the linking rules

Hybrid and branch mismatch arrangements can arise in several ways and, it is possible, that more than one of the hybrid mismatch rules in subpart FH may apply to a taxpayer. Section FH 2 outlines the order in which the hybrid mismatch rules in sections FH 3 to FH 11 should be applied by a taxpayer.

Subsection FH 2(1) outlines the order of the application of the sections that disallow deduction. These are set out in table 2.

**Table 2: The order for applying the rules that disallow deduction**

Order	Section	Rule
1	FH 3	Hybrid financial instrument mismatch – primary rule
2	FH 5	Disregarded hybrid payment mismatch – primary rule
3	FH 7	Payments made to a reverse hybrid
4	FH 11	Imported mismatch
5	FH 8	Deductible payment made by a hybrid entity mismatch – primary rule
6	FH 9	Deductible payment made by a hybrid entity mismatch – defensive rule
7	FH 10	Deductible payment made by dual resident payer mismatch

Subsection FH 2(2) outlines the order of the application of the sections that treat receipts as assessable income. These are set out in table 3.

**Table 3: The order for applying the rules that treat receipts as assessable income**

Order	Section	Rule
1	FH 4	Hybrid financial instrument mismatch – defensive rule
2	FH 6	Disregarded hybrid payment mismatch – defensive rule

## Elections

Sections FH 13 and FH 14 provide that, in some circumstances, taxpayers may opt out of the potential application of the hybrid and branch mismatch rules to some of their arrangements. In particular:

- For inbound hybrid financial instruments, the taxpayer may elect to treat the instrument as a share for New Zealand income tax purposes (section FH 13); and

- For a foreign hybrid entity<sup>3</sup> wholly-owned by a person on 6 December 2017 (the date of the introduction of the Bill), the owner may irrevocably elect to treat the entity as a company for New Zealand income tax purposes (section FH 14). This election must be made by the time the owner files their tax return for the first year in which the hybrid rules apply to the owner.

---

<sup>3</sup> A foreign hybrid entity is one that is fiscally transparent for New Zealand tax purposes and fiscally opaque for the purposes of the foreign country in which it is formed.

## KEY DEFINITIONS

---

### *Section FH 15*

The hybrid and branch mismatch rules introduce a number of new concepts to the New Zealand tax lexicon. We outline the key definitions that apply broadly across the rules below.

### **Financial instrument, hybrid entities and deducting branches**

#### *Financial instrument*

“Financial instrument” is defined in section FH 15. It is relevant for sections FH 3 and FH 4 (and the borrower election to treat a hybrid financial instrument as a share in section FH 13). The definition is intended to encompass all forms of debt and equity. It builds on the existing financial arrangement definition, which is deliberately very broad. There are then a number of additions including for:

- shares; this inclusion may be of less significance given the deductible foreign equity dividend exclusion in section CW 9, but it would be odd to leave shares out of the definition;
- annuities: which are excluded from the financial arrangement rules only because they are taxed under their own regime;
- farm-out arrangements;
- share lending arrangements: share repurchase agreements (share repos), and share lending arrangements which do not meet the statutory definition of a share lending arrangement in section YA 1, are financial arrangements. Share lending arrangements which do meet the statutory definition are excluded from the financial arrangement definition, but should be included as “financial instruments” for the purposes of the hybrid and branch mismatch rules, as they may be hybrid financial transfers, subject to either sections FH 3 or FH 4; and
- loans in New Zealand currency described in section EW 5(10): these are interest-free, repayable on demand loans that are excluded from the financial arrangement definition for the lender.

#### *Hybrid entity*

No entity is inherently a hybrid entity. Hybridity exists only as a result of the inconsistent tax classification of the entity by two countries’ tax systems. This is reflected in the definition of a “hybrid entity” in section FH 15 which provides that it means a person or other entity that is recognised as a person subject to tax (that is, is taxed like a company) in a country that treats it as a tax resident, and not recognised as a person that is subject to tax (that is, is taxed like a partnership or a branch) in another country. For example, a limited partnership may be taxed as a resident entity in the country in which it was incorporated, but taxed as a disregarded (or flow-through) entity in a partner (investor) country.

The hybrid entity definition is relevant for sections FH 8 and FH 9 (primary and defensive rules applying to payments resulting in double deductions) to help to define when those rules

apply, and section FH 14 to define the kind of entity in respect of which an opaque election can be made. The term is also used in sections FH 6 (defensive rule for disregarded hybrid payments mismatches) and FH 12 (which is concerned with surplus assessable income). Although the term is not used in sections FH 5 and FH 6, those sections will often apply to payments made by hybrid entities.

### ***Deducting branch***

“Deducting branch” is defined in section FH 15. It is relevant for sections FH 5 and 6 (primary and defensive rules for disregarded hybrid payment mismatches), sections FH 8 and 9 (primary and defensive rules applying to payments resulting in double deductions) and section FH 11 (imported mismatches).

A deducting branch is a branch, permanent establishment or other activity of a person in a country or territory where the expenditure or loss attributed by the person to the branch is deductible (or gives rise to other tax relief) in that country or territory against income of the person. This includes a deemed permanent establishment under the new rules in respect of permanent establishments.

### **Control groups, related parties and structured arrangements**

The hybrid and branch mismatch rules generally apply when the mismatch is between related parties (broadly twenty five percent common ownership) or control groups (broadly fifty percent common ownership), or the mismatch arises from a payment under a structured arrangement. These terms are defined in section FH 15.

### ***Related***

The definition of “related” is important for sections FH 3 and FH 4 (primary and defensive rules applying to hybrid financial instrument mismatches). It is also relevant to section FH 8 (primary rule applying to payments resulting in double deductions).

The definition of related is closely based on the associated person definitions in subpart YB, except that:

- for two companies, it imposes a twenty five percent common ownership test (rather than a fifty percent common ownership test);
- it applies the same twenty five percent rule to a general partnership as for a limited partnership (which means that a partner in a general partnership is not automatically ‘related’ to that partnership as would be the case for the “associated persons” definition); and
- there is a common control test, which also aggregates interests of persons who act together, as defined in section FH 15.

### ***Control group***

Many of the hybrid and branch mismatch provisions only apply to payments between members of a control group (unless there is a structured arrangement). The “control group” definition in section FH 15 is generally intended to include persons who are commonly controlled or meet a fifty percent common ownership threshold.

For companies and partnerships (whether formed under New Zealand or foreign law) these tests are well established for other purposes, and the definition used in the hybrid and branch mismatch rules incorporates these other definitions.

For trusts, it is more difficult to determine ownership (whether by reason of control or economic interests), and accordingly the legislation uses the same tests that apply to determine whether or not parties are associated in sections YB 5 to 11.

In addition, the meaning of control group has been defined to include:

- members that are consolidated for accounting purposes and/or prepare group financial statements; and
- a common control test, which aggregates the interests of persons who act together, as defined in section FH 15.

### *Act together*

The “act together” definition is relevant for determining whether two persons are in a control group or are related persons by virtue of paragraphs (g) or (h) of the control group and related definitions.

Paragraphs (g) and (h) include two persons in a control group if one effectively controls the other or the same group of persons effectively controls both. In both cases, interests held by persons who are related or who act together are aggregated.

The intent of the acting together test is to:

- prevent taxpayers from avoiding the related party or control group tests by transferring their rights or interests to another person that continues to act under their direction in respect of those interests; and
- target taxpayers who individually hold minority stakes in an entity, but enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into hybrid mismatch arrangements in respect of one or more of them.

The definition of “act together” is highly fact dependent. For instance, two persons will act together if one typically acts in accordance with the wishes of the other, or if their actions are typically controlled by a third person.

There are a number of limbs that determine whether two parties are acting together. The definition is met where two persons (the holders) each have voting rights or equity interests in a person or other entity and at least one of the criteria below are met:

- the holders are associated under section YB 4 (two relatives);
- a holder typically acts in the way preferred by the other holder because of the other holder’s preferences;
- the holders have entered into an arrangement that has an effect on the value or control of the rights or interests that is more than incidental and does not arise from a restriction on the sale of the rights or interests;

- the actions of the holder are controlled or expected to be controlled, whether that be legally or typically, by a third person or group of persons (the co-ordinator);
- the holders and a co-ordinator enter an arrangement affecting the ownership or control of the rights and interests and having an effect on the value or control of the rights and interests that is more than incidental; or
- the holders agree with a co-ordinator that the co-ordinator can act on behalf of the holders in relation to the rights and interests.

Subsection FH 15(2) provides an exclusion from the “act together” definition for the last three limbs above where the co-ordinator manages two investment funds that hold voting rights or equity interests in the same person or entity, but the two funds do not act together in relation to their rights and interests.

We comment on these limbs below.

### *Relatives*

Limb (a) of the definition focuses on natural persons and deems a person to hold any voting rights or equity interests that are held by members of that person’s family as determined under section YB 4 (Relatives).

### *Typically acts in the way preferred by the other holder*

Under limb (b) of the definition, a person will be treated as acting in the way preferred by another holder where the person is legally bound to act in accordance with the other holder’s instructions or if it can be established that the person is expected to act, or typically acts, in accordance with the other holder’s instructions. The focus of the test is on the actions of that person in relation to the voting rights or equity interests.

The test is not intended to treat as acting together two or more shareholders that typically vote in a similar way to each other, but make their decisions independently and without reference to each other. It is intended to apply where a holder typically acts in a way preferred by another holder because it is preferred by the other holder.

### *Entered into an arrangement that has a more than incidental effect on the value or control of the rights and interests*

Under limb (c) of the definition, a person will be treated as holding the equity or voting interests of another person if they have entered into an arrangement that has an effect on the value or control of the rights or interests that is more than incidental. The test covers arrangements concerning the exercise of voting interests and/or regarding beneficial entitlements, such as an entitlement to profits or eligibility to participate in distributions. In addition, it covers arrangements concerning the ownership of those rights, such as options to sell rights.

The test is intended to capture arrangements that are entered into with other investors and does not cover arrangements that are simply part of the terms of the equity or voting interest concerned, or that operate solely between holder and issuer.

The arrangement regarding the control of the voting rights or equity interests must have a more than incidental effect on the value of those rights or interests. The more than incidental

threshold means that an investor will not have their rights or interests treated as part of a common holding arrangement simply because the investor is party to a commercially standard shareholder agreement that does not have a significant impact on the ability of the investor to exercise ownership or control over their interests.

**Example 1: Commercially standard shareholder agreement**

Aardvark Co together with a number of other investors holds one hundred percent of the shares in Badger Co. Aardvark Co is the single largest shareholder holding forty percent, with the remaining 12 investors each holding five percent. The shareholders enter into a shareholders' agreement that provides Aardvark Co with a first right of refusal on any disposal of the shares and drag-along and tag-along provisions in the event that an offer is made for a majority of the shares in Badger Co.

*Question*

Whether Aardvark Co and the other investors in Badger Co are acting together within the scope of limb (c) of the definition?

*Answer*

No (generally). The right to buy other shareholders' shares at market value, as well as the drag along and tag along rights are relatively standard terms in a shareholders' agreement for a company that is not widely held. These types of provisions will not generally have a material impact on the value of the holder's equity interest and therefore should not be taken into account for the purposes of limb (c) of the acting together requirement.

**Example 2: Shareholders subscribe for proportional debt**

There are 10 investors in Crab Co with each holding ten percent of its shares. The 10 investors enter into a shareholders' agreement to subscribe for proportional debt in Crab Co. The proportional debt is a hybrid financial instrument for some of the investors, but not all of them, depending on their tax residence. The 10 investors each voted positively for Crab Co to issue the proportional debt, but exercised their voting rights independently of each other.

*Question*

Whether the investors in Crab Co are acting together within the scope of limb (b) or (c) of the definition?

*Answer*

No (generally). If some, or (in this case) all, of the investors agree that they will fund the company pro rata in a certain way, that should not, in and of itself, mean that the investors typically act in the way preferred by the other holders because of the holder's preference per limb (b). While the shareholders' agreement may provide for the issue of proportional debt, it should not generally have a more than incidental impact on the value of the shares. For instance, if Crab Co issues \$10m of debt, both its assets and liabilities should increase by \$10m, leaving the value of its equity unchanged so limb (c) should not apply.

*Co-ordinator*

Under limbs (d) to (f) of the definition, two persons or a group of persons will be treated as acting together if their interests are managed, controlled or affected in a way that is more than merely incidental by another person or group of persons (the co-ordinator).

These limbs will not apply to a co-ordinator that manages two investment funds that hold voting rights or equity interests in the same person or entity, if the two funds do not act together in relation to their rights and interests.

### **Example 3: Co-ordinator**

Take the facts of example 2, except that each investor invests through an investment partnership that holds one hundred percent of Crab Co. The investment partnership has a general partner that decides on the investments of the partnership. The investment partnership makes a debt investment in Crab Co. This debt is a hybrid financial instrument for some of the investors, but not all of them as they are resident in different countries.

#### *Question*

Whether the investors of the partnership are acting together due to the presence of a co-ordinator within the scope of limbs (d) to (f)?

#### *Answer*

The partners can be considered to be acting together in relation to their interest in Crab Co via their investment partnership under limb (d) of the definition as their investments are controlled by the general partner. The partners will also be acting together based on the partnership agreement if that provides for the decision-making rights of the general partner. (Note that the exception to the co-ordinator rule in FH 15(2) does not apply on these facts as there is only one relevant investment vehicle.)

### ***Structured arrangement***

The “structured arrangement” definition in section FH 15 is relevant throughout the hybrid and branch mismatch rules. This is because it is used to define the situations where a hybrid or branch mismatch between persons who are not related or in a control group is subject to the rules.

#### *OECD recommendation*

The structured arrangement definition is consistent with recommendation 10 of the OECD hybrid mismatch report. In this regard, paragraphs 318 to 319 of the report state that:

“The purpose of the structured arrangement definition is to capture those taxpayers who enter into arrangements that have been designed to produce a mismatch in tax outcomes while ensuring taxpayers will not be required to make adjustments under the rule in circumstances where the taxpayer is unaware of the mismatch and derives no benefit from it.

The test for whether an arrangement is structured is objective. It applies, regardless of the parties’ intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes. The structured arrangement rule asks whether the mismatch has been priced into the terms of the arrangement or whether the arrangement’s design and the surrounding facts and circumstances indicate that the mismatch in tax outcomes was an intended feature of the arrangement.”

These principles have been taken into account in incorporating the definition of structured arrangement into domestic legislation.

#### *Definition*

The definition of a structured arrangement can be broken into two parts.

The first limb in (a) outlines two (potentially overlapping) circumstances that will be a structured arrangement. The first is where the pricing is based on the existence of a hybrid

mismatch. The second is where the facts or circumstances indicate that the arrangement is intended to rely on or produce a hybrid mismatch.

The second limb in (b) is person-specific and reflects that a structured arrangement should only exist for a person where they (or a member of their control group) could reasonably have been expected to have been aware of the mismatch regardless of whether they benefited from it or not. This means that it is possible, albeit not necessarily common, that what may be a structured arrangement to one person will not be a structured arrangement to another.

We discuss these elements of the definition below.

#### Price assumes existence of a hybrid mismatch

The price of the arrangement will assume the existence of a hybrid mismatch if the mismatch has been factored into the calculation of the return under the arrangement.

This test looks to the actual terms of the arrangement, as they affect the return on the arrangement, and as agreed between the parties, to determine whether the pricing of the transaction is different from what would have been agreed had the mismatch not arisen.

This is a legal and factual test that looks only to the terms of the arrangement itself and the allocation of risk and return under the arrangement, rather than taking into account broader factors such as the relationship between the parties or the circumstances in which the arrangement was entered into. The test would not take into account the consideration paid by a taxpayer to acquire a hybrid financial instrument from another holder (for example, where the instrument is acquired at a premium or a discount from a third party) unless the instrument is issued and sold as part of the same arrangement.

#### **Example 4: Hybrid mismatch priced into the terms of the arrangement**

Dolphin Co (a company resident in Country D) and Elk Co (a company resident in Country E) are unrelated parties. Elk Co issues a bond that pays an annual coupon to Dolphin Co. The bond is treated as a debt instrument under the laws of Country E but as an equity instrument under the laws of Country D. Country D generally exempts foreign dividends under its domestic law but taxes interest income. Therefore the payment results in a D/NI outcome that is a hybrid mismatch.

The formula for calculating the coupon payment on the bond provides for a discount to the market rate of interest which is calculated by reference to the company tax rate in Country D (that is, the coupon formula is equal to  $market\ rate \times (1 - 0.5\ of\ the\ tax\ rate)$ ).

#### *Question*

Whether the bond is a structured arrangement for Elk Co?

#### *Answer*

Yes. The mismatch has been factored into the calculation of the coupon under the bond so limb (a)(i) of the definition is met. Elk Co could reasonably be expected to be aware of the sharing of the tax benefit that arises to it from the mismatch as the coupon formula reflects a below market rate of interest so limb (b) of the definition is met as well.

### Facts or circumstances indicate an intention to rely or produce a hybrid mismatch

The facts and circumstance test is a wider test than the pricing test noted above and looks to a number of factors to determine whether the arrangement is intended to rely on or produce a hybrid mismatch. These factors include the relationship between the parties, the circumstances under which the arrangement was entered into, the steps and transactions that were undertaken to put the arrangement into effect, the terms of the arrangement itself and the economic and commercial benefits of the transaction

Facts and circumstances that indicate an arrangement is intended to produce a hybrid mismatch include the following:

- an arrangement that is designed, or is part of plan, to create a hybrid mismatch;
- an arrangement that incorporates a term, step or transaction to create a mismatch;
- an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage is derived from the hybrid mismatch;
- an arrangement that is primarily marketed to taxpayers in a country where the hybrid mismatch arises;
- an arrangement that contains features that alter the terms under an arrangement, including the return, in the event that the hybrid mismatch is no longer available; and
- an arrangement that would produce a negative return absent the hybrid mismatch.

The fact that an arrangement produces a combination of tax and commercial benefits does not prevent the arrangement from being a structured arrangement if, on an objective basis, it would be concluded that part of the explanation for the arrangement was to generate a hybrid mismatch.

### Reasonably be expected to be aware

Whether an arrangement is a structured arrangement is person-specific as it depends on whether a person (or a member of that person's control group) could reasonably have been expected to be aware of the mismatch.

This limb of the definition is consistent with paragraphs 342 to 343 of the OECD hybrid mismatch report which state that:

“A person will be a party to a structured arrangement when that person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer nor any member of the same control group was aware of the mismatch in tax outcomes or obtained any benefit from the mismatch.

The test for whether a person is a party to a structured arrangement is intended to capture situations where the taxpayer or any member of the taxpayer's control group was aware of the mismatch in tax outcomes and should apply to any person with knowledge of the arrangement and its tax effects regardless of whether that person has derived a tax advantage under that arrangement.”

### **Example 5: Arrangement marketed as a tax-advantaged product**

Flamingo Co (a company resident in Country F) subscribes for bonds paying an annual coupon issued by Gorilla Co (an unrelated company resident in Country G). Flamingo Co subsequently sells the bond to Hedgehog Co, another unrelated company resident in Country H.

Due to differences in the treatment of the underlying instrument under the respective laws of Country G and Country H, the coupon payments give rise to a hybrid mismatch resulting in a D/NI outcome.

Flamingo Co subscribed for these bonds after receiving an investment memorandum that included a summary of the expected tax treatment of the instrument (including the fact that payments on the instrument will be eligible for tax relief in Country H). A similar investment memorandum was sent to a number of other potential investors in Country H.

#### *Question 1*

Whether the bond is a structured arrangement for Flamingo Co?

#### *Answer 1*

The bonds will give rise to a structured arrangement to Flamingo Co because: (i) the facts indicate that the bond has been marketed as a tax-advantaged product and has been primarily marketed to persons who can benefit from the mismatch; and (ii) Flamingo Co acquired the bond on initial issuance and was aware of the potential mismatch in tax treatment from the investment memorandum.

However, provided F Co is taxable on the return from the bonds, there is no D/NI mismatch to counter.

#### *Question 2*

Whether the bond is a structured arrangement for Hedgehog Co?

#### *Answer 2*

Whether or not the bonds are a structured arrangement to Hedgehog Co will depend on the facts. The bond was marketed as a tax-advantaged product and was primarily marketed to persons who could benefit from the mismatch, including persons in Country H. However, it may not be a structured arrangement to Hedgehog Co, if Hedgehog Co paid market value for the bond and could not reasonably have been expected to be aware of the mismatch in tax treatment.

### ***Hybrid mismatch***

The “hybrid mismatch” definition is used in section FH 11, the imported hybrid mismatch section, and the definition of structured arrangement. It is a broad definition that effectively covers D/NI and DD mismatch arrangements.

### ***Hybrid mismatch legislation***

“Hybrid mismatch legislation” is defined to mean subpart FH and legislation of other countries or territories that has an intended effect corresponding to subpart FH (or a provision in subpart FH). In this regard, foreign legislation will correspond to subpart FH if it is consistent with the effect of the recommendations of the OECD hybrid mismatch report and/or branch mismatch report.

This question is most relevant for the defensive rules in sections FH 4, 6 and 9, because if the foreign country has an equivalent of the corresponding primary rule then the taxpayer will not apply the defensive rule in New Zealand.

Whether foreign legislation has an intended effect corresponding to the hybrid mismatch rules will need to be determined at the time of the mismatch. For example, if another country has a rule that denies deductions for duplicate tax losses this could be considered to have the same effect as hybrid rules relating to DD mismatches. The other country would not need to have rules that correspond to each of the recommendations in the OECD hybrid report and/or branch report. It would only need to have a rule that corresponds to the particular hybrid or branch mismatch that would be countered in New Zealand if not addressed by the foreign country.

It is not expected that another country's legislation will be exactly the same as New Zealand's. This means that the amount that New Zealand might counteract, in a given situation, could be different from that which would be counteracted by another country's rules in that same situation. Alternatively, another country's rules may only apply to certain types of payments (for example, interest and royalty payments but not others). These circumstances should not prevent that other country's rules qualifying as hybrid mismatch legislation. However, the question of whether a defensive rule in subpart FH applies or not is not determined simply by whether or not the other country has hybrid rules. For instance, section FH 6, which is discussed in detail below, is a defensive rule that only grants priority to another country's hybrid mismatch legislation if that country's rule applies to the relevant payment and payer in the income year.

The US dual consolidated loss (DCL) rules are an example of hybrid mismatch legislation. Inland Revenue understands that these rules generally operate as follows:

- A US company is denied the ability to reduce its US tax in relation to losses that are used under the laws of a foreign country to offset income that is not taxed by the US. These may be losses incurred by a foreign branch of the US company, through a foreign hybrid owned by the US company, or by a dual resident company.
- The denial can be turned off if the US company makes a domestic use election. This election requires the company to elect not to use the loss under the laws of another country to offset income which the US does not tax. The non-foreign use period is limited to five years following the year of the loss.
- If a domestic use election is made, but the loss is used to offset income which the US does not tax during the five year period, or other "triggering events" occur (such as a sale of the foreign hybrid that incurs the loss), the US tax reduction resulting from the US use of the loss is recaptured and there is also an interest charge. If the loss is so used (or another triggering event occurs) after the five year period, there is no penalty.

On the basis of this understanding, the US DCL rules appear to be hybrid mismatch legislation corresponding to section FH 8. Expenditure incurred by a US taxpayer, or a New Zealand hybrid entity which is deductible by a US owner, will not be subject to section FH 9 so long as the US taxpayer is subject to the DCL rules and has not made a domestic use election. If the US taxpayer has made a domestic use election, then section FH 9 will apply to deny a deduction for the expenditure. That is because the domestic use election is an election that the DCL rules do not apply to the US taxpayer in respect of the relevant expenditure. During the five year "non-foreign use" period imposed by the terms of the domestic use election, this should not be a practical issue, since the terms of the domestic use election will

in any event prohibit the use in New Zealand of that expenditure against income which the US does not tax. Once that period has passed, the US DCL rules will not deny the US person the ability to use the expenditure in New Zealand against income which the US does not tax. However, section FH 9 will continue to apply, to similar effect.

### ***Mismatch situation***

“Mismatch situation” means a situation giving rise to denial of a deduction, or assessable income, under sections FH 5, FH 6, or FH 8 to FH 10. The definition is important as mismatch situations result in “mismatch amounts” discussed below, which are where the hybrid counteraction may be offset against surplus assessable income in section FH 12. A situation can be a mismatch situation in a year even if there is no denial of a deduction (or inclusion of income under FH 6) in the relevant year.

A person can be involved in more than one mismatch situation. Further, a single mismatch situation can give rise to more than one kind of mismatch. For instance, a New Zealand resident hybrid entity can make payments which are subject to both section FH 5 (because they are made to a foreign owner who disregards the entity) and section FH 9 (because they are deductible in New Zealand and a foreign country).

### ***Mismatch amount***

“Mismatch amount” means an amount, arising from a mismatch situation, for which a deduction may be allowed under section FH 12 when the amount is set off in a tax year against an amount of surplus assessable income. It can only arise from “mismatch situations”.

# HYBRID FINANCIAL INSTRUMENT RULE

---

## Sections FH 3 and FH 4

### Background

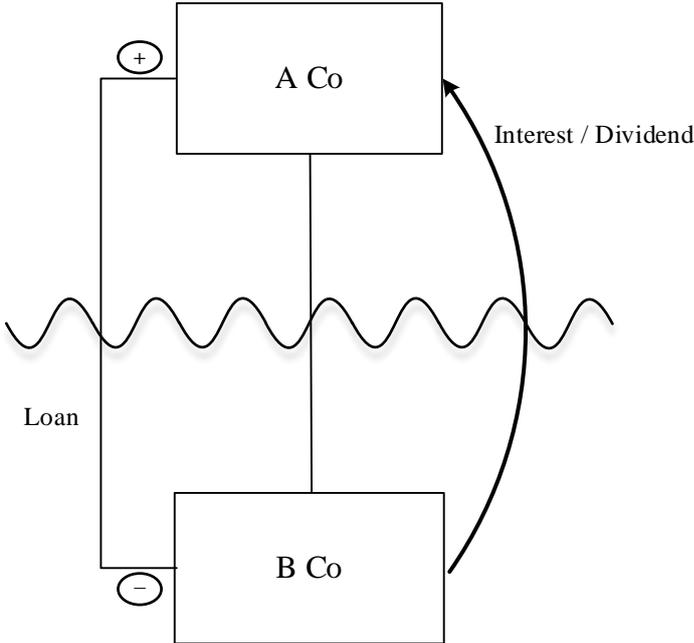
The hybrid financial instrument rule is recommendation 1 of the OECD hybrid mismatch report and addresses D/NI mismatches.

Hybrid mismatches that fall within the scope of the hybrid financial instrument rule in sections FH 3 and FH 4 can be split into two categories: character mismatches and timing mismatches.

Recommendation 2.1 of the OECD hybrid mismatch report which recommends that countries should not grant an exemption for dividends that are treated as deductible in a foreign country, is also important in considering the application of this rule.

### Character mismatch

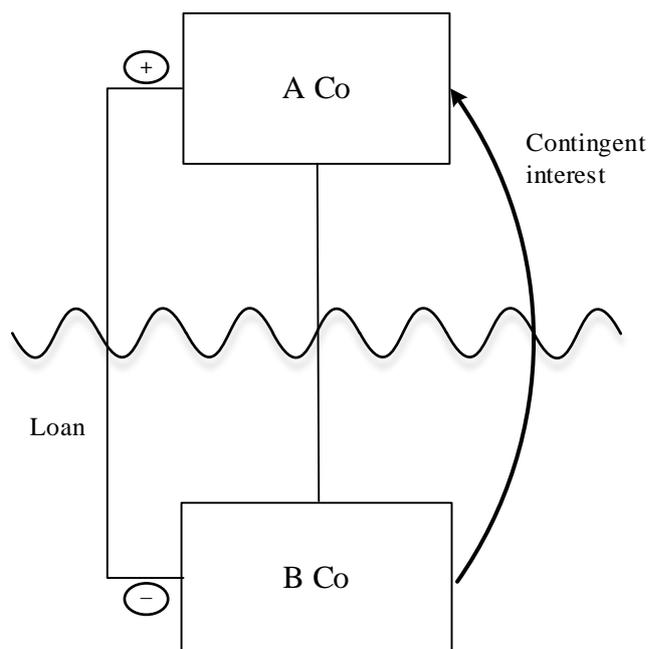
The following diagram illustrates a character mismatch arising from a financial instrument that pays coupons:



In this character mismatch, the financial instrument (loan) is treated as debt by B Co and the coupons are treated as deductible interest. However, the instrument is treated as equity by A Co and the coupons are treated as non-assessable dividends. This results in double non-taxation.

### Timing mismatch

The following diagram illustrates an example of a timing mismatch arising from a financial instrument that pays interest upon maturity:



In this timing mismatch, A Co and B Co enter into a five-year term loan where interest accrues on the loan, but is only payable at maturity or earlier at the discretion of B Co. The loan is treated as debt by both A Co and B Co. Interest payments on the loan are treated as deductible by B Co in the year the interest accrues but will only be treated as income by A Co when (and if) such interest is actually paid. This results in double non-taxation in the sense that there is a significant deferral (five years) between when the interest is deductible to B Co and when it is assessable to A Co.

### Summary of legislative response

Sections FH 3 and FH 4 implement recommendation 1 of the OECD hybrid mismatch report. They are respectively the primary and defensive rules relating to hybrid financial instruments (which include, but are not limited to, financial arrangements plus shares).

Section FH 3 is the primary rule and applies to inbound investment to deny a New Zealand income tax deduction for a payment under a hybrid financial instrument taking into account the extent to which it is subject to tax in the payee country.

Section FH 4 is the defensive rule and applies to outbound investment to tax a payment under a hybrid financial instrument in New Zealand taking into account the extent to which it is deductible in the payer country. Section FH 4 is expected to have limited application in New Zealand as deductible payments under a hybrid financial instrument would not qualify as exempt foreign dividends under existing section CW 9.

The definition of “deductible foreign equity distribution” has also been amended in section YA 1.

## Application date

Sections FH 3 and 4 apply for income years beginning on or after 1 July 2018. This means that section FH 3 applies to payments for which deductions are claimed in that income year or subsequently. The date on which the payment giving rise to the deduction is paid is not relevant. Section FH 4 on the other hand applies only to payments received on or after the start of a person's income year beginning on or after 1 July 2018.

There is an exception to section FH 3 for banking and insurance regulatory capital entered into on or before 6 September 2016 (the date the Government discussion document *Addressing hybrid mismatch arrangements* was released). Such regulatory capital is grand-parented until the first date on which the issuer has an unconditional right to call or otherwise cancel the financial instrument without penalty.

## Detailed analysis

### *Section FH 3 – primary rule*

Section FH 3 is the primary rule of recommendation 1 of the OECD hybrid mismatch report. It applies with priority over the defensive rules of foreign countries. It applies when a person is a party to a financial instrument under which the person makes a payment if:

- the person incurs in an income year expenditure that relates to the financial instrument and does not arise solely from a foreign exchange fluctuation;
- the expenditure is deductible (in the absence of the hybrid mismatch rules);
- the tax law of a country outside New Zealand treats the payment when made as received by a person in that country (who may be a resident of that country or a non-resident carrying on business there). It does not matter if the other country will not treat the payment as received until a later year than the year in which the deduction arises in New Zealand;
- the financial instrument is or is part of a structured arrangement or the payer and payee are related; and
- the tax treatment of the payee in its country meets either subsection (2) or subsection (3). Subsection (2) relates to character mismatches and subsection (3) relates to timing mismatches.

#### **Example 6: No mismatch with respect to measurement of foreign exchange differences**

Falcon Co (a company resident in Country F) owns all the shares in Kiwi Co (a company resident in New Zealand). Falcon Co provides Kiwi Co with an ordinary loan denominated in F\$ (FD). Interest on the loan is payable annually in arrears at a market rate and the principal on the loan is payable at maturity. The loan is treated as a debt instrument under the laws of both Country F and New Zealand and the countries take a consistent position on the characterisation of the payments made under the loan. The interest payable on the loan is deductible in Kiwi Co and included in ordinary income under the laws of Country F.

The value of NZD falls in relation to FD while the loan is still outstanding so that payments of interest and principal under the loan become more expensive in NZD terms. Under NZ law, Kiwi Co is entitled to a deduction for this increased cost. There is no similar adjustment under Country F law as it is simply receiving the payments it expected to receive in FD.

*Question*

Whether the adjustment under New Zealand law for the increase in costs attributable to the fall in the value of NZD against FD gives rise to a hybrid mismatch within the scope of the hybrid financial instrument rule in section FH 3?

*Answer*

No. While the fall in the value of NZD gives rise to a deduction under NZ law that is not reflected by a corresponding inclusion in Country F, this difference does not give rise to a D/NI outcome provided the proportion of the interest and principal payable under the loan is the same under the laws of both countries. Gains and losses that result from converting foreign exchange into local or functional currency are attributable to the way countries measure the value of money, rather than the value of the payment itself.

*Character mismatches*

Subsection (2) applies to character mismatches. Character mismatches arise if two criteria are met.

The first criterion is that neither the foreign payee country, nor any other foreign country, recognises the payment as ordinary income of the payee. For instance, if the foreign payee's country of residence did not recognise the payment as ordinary income, but it was included as part of the ordinary income of the payee in another country through a branch, then the first criterion would not be met (that is, there could be no character mismatch).

The second criterion is that the payment would be recognised as ordinary income in the payee country if the classification of the payment or payment instrument were varied, and the payee had the usual tax status for a person or entity of the payee's class. This criterion is based on two key principles:

- *The rule should only apply where the mismatch in tax treatment between the two countries is attributable to how the payee and payer countries treat the instrument for tax purposes*

The primary example of a character mismatch is where the payer country treats the instrument as debt and the payee country treats the instrument as equity resulting in deductible interest in the payer country and exempt dividends in the payee country. The D/NI mismatch in such a case is attributable to the classification of the payment or payment instrument.

The test the legislation effectively sets is whether the D/NI mismatch would cease to exist if the payee country treated the financial instrument and/or payment in the same way as the payer country. Taking this approach to the example in the preceding paragraph, if the payee country treated the instrument as debt (instead of equity), it would treat the payments received as interest (rather than dividends). Therefore, as long as the interest payments would be treated as ordinary income in the payee country (assuming a usual tax status of the payee as discussed below), the D/NI mismatch would cease to exist, which means that there is a character mismatch.

- *The rule should not apply where the mismatch is solely attributable to the status of the taxpayer or the context in which the instrument is held*

This reflects that D/NI results can be due to factors other than the hybridity of a financial instrument. However, character mismatches should only arise because of the contrasting ways in which the payee and payer countries treat the instrument for tax purposes.

For example, a vanilla loan paying interest could produce a D/NI result where the payee is a sovereign wealth fund or tax resident in a country with no income tax or a territorial tax regime. However, this would not be a hybrid mismatch.

The test the legislation applies is whether the mismatch would still arise if the instrument was a debt instrument in the payee country, and entered into by a payee of usual or ordinary status for a person in the payee's class. If it would, then the mismatch should be attributed to the classification of the instrument, rather than the status of the taxpayer or the context in which the instrument is held, and section FH 3 can apply to the New Zealand payer.

#### **Example 7: Hybrid financial instrument**

Zebra Co (a company resident in Country Z) owns all the shares in Kiwi Co (a company resident in NZ). Zebra Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of NZ Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. New Zealand treats the subordinated loan as a debt instrument, while Country Z treats the loan as akin to equity and treats payments under the loan as exempt foreign-sourced dividends.

The payments on the loan fall within the scope of the hybrid financial instrument rule. Country Z's does not recognise the arrangement between Zebra Co and Kiwi Co as giving rise to ordinary income for Zebra Co, as it is an exempt dividend that is not taxed at the payee's full marginal rate. If the classification of the arrangement were varied such that Country Z viewed the arrangement as an ordinary loan, the dividends would be recognised as interest income that is fully taxable to Zebra Co. As a result, the counterfactual requirement in FH 3(2) is satisfied. Kiwi Co is denied a deduction for its interest expenditure under FH 3(4).

#### **Example 8: Interest payment to an exempt person**

Elephant Co (a company resident in Country E) owns forty percent of the shares in Kiwi Co (a company resident in NZ). Elephant Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of NZ Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. Both Country E and New Zealand treat the subordinated loan as a debt instrument.

Elephant Co is a sovereign wealth fund established under Country E law that is exempt from tax on all income. E Co is therefore not taxable on the interest payment.

#### *Question 1*

Whether the interest payments under the loan fall within the scope of the hybrid financial instrument rule in section FH 3?

#### *Answer 1*

No. The interest payments under the loan give rise to a mismatch in tax outcomes as they are deductible under NZ law, but are not included in ordinary income under Country E law. However, the D/NI result is not dependent on the classification of the financial instrument (that is, the subordinated loan). Rather, it applies solely because of the tax exempt status of Elephant Co as a sovereign wealth fund. The mismatch in tax outcomes would not have arisen had the interest been paid to a taxpayer of usual status (say a company), so cannot be attributed to the classification of the instrument.

*Question 2*

Whether the outcome above changes if the subordinated loan is instead a hybrid financial instrument that is treated as an equity instrument by Country E (with dividends treated as exempt) but a debt instrument by New Zealand (with interest treated as deductible)?

*Answer 2*

Yes. The D/NI result now arises for two reasons: (1) Elephant Co is a tax exempt sovereign wealth fund; and (2) Country E treats the hybrid financial instrument as an equity instrument but Kiwi Co treats it as a debt instrument. Whether there is a character mismatch under subsection FH 3(2) then depends on whether there would be a D/NI result if Elephant Co had the usual tax status for a person of the its class (say a company in this case). This will depend on how Elephant Co would be taxed if it were not specifically tax exempt. Suppose Elephant Co takes the form of a trust, which would be taxed on the instrument if it were treated as interest in Country E. In that case there would be a character mismatch under subsection FH 3(2).

**Example 9: Interest payment to a person established in a no-tax jurisdiction**

Horse Co (a company resident in Country H) owns all the shares in Kiwi Co (a company resident in New Zealand). Horse Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of Kiwi Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. Both H Co and Kiwi Co treat the subordinated loan as a debt instrument.

Country H does not have a corporate tax system and Horse Co does not have a taxable presence in any other country. Horse Co is therefore not liable in any country on payments of interest under the loan.

*Question 1*

Whether the interest payments under the loan fall within the scope of the hybrid financial instrument rule in section FH 3?

*Answer 1*

No. The interest payments under the loan give rise to a mismatch in tax outcomes as they are deductible under New Zealand law, but are not included in ordinary income under Country H law. However, the D/NI result is not dependent on the classification of the financial instrument (that is, the subordinated loan). Rather, it applies because Country H does not have a corporate tax system for any taxpayers.

*Question 2*

Whether the outcome above changes if the subordinated loan is instead a hybrid financial instrument that is treated as an equity instrument by Horse Co but a debt instrument by Kiwi Co (with interest treated as deductible)?

*Answer 2*

No. The D/NI result would still arise if Horse Co treated the subordinated loan as a debt instrument (mirroring Kiwi Co's treatment of it). This is because Country H has no corporate tax system.

**Example 101: Interest payment to a taxpayer resident in a territorial tax regime**

Tiger Co (a company resident in Country T) owns all the shares in Kiwi Co (a company resident in New Zealand). Tiger Co lends money to Kiwi Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of Kiwi Co and can be suspended in the event Kiwi Co fails to meet certain solvency requirements. Both Tiger Co and Kiwi Co treat the subordinated loan as a debt instrument.

Country T has a pure territorial tax system and does not tax income unless it has a domestic source. Interest income paid by a non-resident is treated as foreign source income and is exempt from tax.

*Question 1*

Whether the interest payments under the loan fall within the scope of the hybrid financial instrument rule in section FH 3?

*Answer 1*

No. The interest payments under the loan give rise to a mismatch in tax outcomes as they are deductible under New Zealand law, but are not included in ordinary income under Country T law. However, the D/NI result is not dependent on the classification of the financial instrument (that is, the subordinated loan). Rather, it applies because Country T taxes on a purely territorial basis.

*Question 2*

Whether the outcome above changes if the subordinated loan is instead a hybrid financial instrument that is treated as an equity instrument by Tiger Co but a debt instrument by Kiwi Co (with interest treated as deductible)?

*Answer 2*

No. The D/NI result would still arise if Tiger Co treated the subordinated loan as a debt instrument (mirroring Kiwi Co's treatment of it). This is because Country T has a pure territorial tax system and the interest income paid by a non-resident is treated as foreign source income.

Ordinary income is defined in subsection (9). It is income taxed at the full (or usual) marginal rate of a person for income from financial instruments, and which is not eligible for any exemption, exclusion, credit or tax relief, other than for withholding tax imposed on the payment.

**Example 11: Ordinary income**

An offshore parent tax resident in Country A lends money to a New Zealand subsidiary on the basis that the loan is subordinated to general creditors and interest payments are subject to a solvency requirement. If the interest is not paid, it compounds. The loan is treated as a share under Country A tax law, and payments are treated as dividends. Country A taxes only ten percent of any dividend received from a foreign subsidiary. The tax rate imposed on this ten percent is the same as the tax rate imposed on interest income.

In this case, ninety percent of the interest payment is not taxed as ordinary income. However, it would be taxed as ordinary income if the loan were treated as a debt instrument for purposes of Country A tax law. Accordingly, the payment meets the requirements of subsection FH 3(2).

*Alternative 1*

Country A also has a rule that denies the ninety percent exclusion to dividends from foreign subsidiaries if they are deductible to the subsidiary (similar to section CW 9(2)(c) of the Income Tax Act 2007). In this case section FH 3 would not apply. The dividend would remain deductible, since it is taxable as ordinary income to the offshore parent.

It should not matter if there is a timing difference between when the payment is treated as deductible to the New Zealand subsidiary (that is, interest deducted on an accrued basis under the financial arrangements rules) and when it is taxable to the offshore parent (that is, when it is received) under subsection FH 3(2), unless subsection FH 3(3) relating to timing mismatches applies.

*Alternative 2*

The loan from the offshore parent is to the New Zealand branch of a subsidiary also resident in Country A, and the offshore subsidiary and the offshore parent are in a tax consolidated group in Country A, pursuant to which payments between the two companies are disregarded for Country A tax purposes. In that case, the payment would not be included in the offshore parent's income regardless of the classification of the payment or the loan. Accordingly, the payment is not subject to section FH 3 (though it may well be subject to section FH 5).

### *Timing mismatches*

Subsection (3) applies to "timing mismatches". These arise if:

- an amount of a payment is recognised as ordinary income;
- the financial instrument, including extensions contemplated by the financial instrument, does not have a duration of three years or less; and
- the payee is not using a reasonable accrual method to recognise income from the payment and the payment is not, or is not reasonably expected to be, recognised in the payee country in an accounting period beginning within 24 months of the year in which the amount is deductible.

#### **Example 12: Timing mismatch I**

An offshore parent company makes an advance to a New Zealand subsidiary company, with interest accruing but payable only if demanded by the parent. The loan has no specified maturity date. The New Zealand subsidiary deducts interest as it accrues, but the parent only has to recognise the interest when it is paid under the tax law in its country of residence.

In this case, although demand for repayment of the advance could be made at any time, there is no requirement for the advance to be repaid within three years, so the three year de minimis does not apply. In the absence of section FH 3, the group can expect to generate a tax advantage by the subsidiary not paying the interest. Accordingly, unless there is some evidence to support an expectation that the interest will be paid within the required period, the interest payment will be subject to deduction denial under subsection FH 3(4).

If the offshore parent does receive payment of the interest in the future, the New Zealand subsidiary will receive a deduction for the interest previously denied under subsection FH 3(7) to the extent the interest payment is recognised as income by the parent.

### *Hybrid counteraction*

Subsection (4) defines the amount for which the payer is denied a deduction when subsection (1) is satisfied. The deduction has two components.

The first component is for the incurred amount. This is the expenditure incurred by the payer relating to the payment instrument and the payee. For financial instruments denominated in a foreign currency, the expenditure should be calculated taking into account the effect of changes in the NZD value of both the principal amount and the payment itself (to the extent these changes are otherwise taken into account in determining income). In such cases, the incurred amount in subsection (4) is also intended to include both amounts.

The second component is a formula with a fraction, which is:  $1 - \text{payee tax} / \text{ordinary tax}$ . This is intended to reduce the deduction denied to the extent that foreign tax is imposed on the payment.

Payee tax is the total of:

- the tax to which the payment is liable in the payee country within the timing in subsection (6). This could be tax on income recognised in payee country in the same year as the deduction is claimed in the payer country, but also includes tax on income recognised in an accounting period beginning within 24 months of the year in which the deduction is claimed in the payer country. It is calculated by multiplying the amount of the payment that is recognised as income by the applicable rate of tax; and
- the amount of income tax actually imposed on the income under CFC rules in another country again within the timing in subsection (6). In relation to this second element, there must be actual tax payable on the income. This test will not be met if the CFC tax is reduced by losses or credits, other than credits for withholding tax imposed by New Zealand on the payment.

Ordinary tax is the amount of tax which would be imposed on the payment if it were ordinary income in the payee country.

#### **Example 13: Timing mismatch II**

Take the facts of example 12. In this case:

- the incurred amount is the deduction claimed by the payer in a given year; and
- if a payment is made within the 24-month timing in subsection (6) for which the deduction is claimed, “payee tax” will include an amount equal to ten percent of the payment times the payee’s ordinary tax rate. The formula in section FH 3(4) will deny a deduction for the incurred amount times ninety percent. Otherwise payee tax will be zero, even if tax is paid by the payee outside the 24-month timing in subsection (6).

#### **Example 14: Timing mismatch III**

Take again the facts of example 12. It is now determined that the amount for which a deduction is claimed is not likely to be included in the offshore parent’s income within the required time period, so that section FH 3 does apply to the expenditure. In this case:

- the incurred amount is the deduction claimed by the payer in a given year; and
- unless there is some evidence to the contrary, it would be reasonable to conclude that no payment is expected to be made within the required time period in subsection (6) in which the deduction is claimed (if it were, there would be no timing mismatch). So there will be no payee tax.

Subsection (7) applies to amounts for which a deduction is denied because of a timing mismatch (that is, the amounts fall within subsection (6)). Once the payment is recognised as ordinary income in the payee country, the payer is allowed a deduction for the amount previously denied under subsection (4).

The intention of subsection (8) is to deal with the effect of foreign currency gains of a person who, but for such gains, would be denied a deduction for expenditure incurred under a

financial arrangement because it falls within subsection (2). If such a person has net income from the financial arrangement due to the foreign currency gain, subsection (8) provides that the income will be excluded income. If the deduction for the payment would have been only partially denied, the income is excluded income in the same proportion.

### ***Section FH 4 – defensive rule***

Section FH 4 is the defensive rule of recommendation 1 of the OECD hybrid mismatch report.

Section FH 4 applies when a person subject to New Zealand tax receives a payment under a financial instrument if:

- the payment would not give rise to assessable income of the payee, or gives rise to assessable income not meeting the timing requirements in subsection (7). The timing requirements are that the income must be allocated to an accounting period beginning within 24 months of the end of the accounting period to which the deduction is claimed in the payer country;
- the payment is treated in another country as deductible (or entitled to equivalent tax relief) to a person in that country;
- that country does not have an equivalent to section FH 3 (the primary rule for hybrid financial instruments);
- the financial instrument is part of a structured arrangement or the payee and payer are related; and
- the payment meets the requirements of subsection (2) or (3). Subsection (2) relates to character mismatches and subsection (3) relates to timing mismatches.

### ***Character mismatches***

Subsection (2) applies to character mismatches, which arise when a payment does not give rise to assessable income to the payee, but would do so if the classification of the payment or the financial instrument were varied.

Generally, it is not expected that subsection (2) would apply to a dividend, since New Zealand already taxes deductible dividends (as the section CW 9 exemption does not apply to deductible dividends). Nor is it intended that section FH 4 would apply to payments under a finance lease where the payer in another country treats the lease as an operating lease and claims a deduction for the entire amount of the payment. In this case, so long as the instrument remains a financial instrument, there is no variation to its terms that would result in the payments being assessable to the extent they represent a payment of principal in respect of the deemed loan under the finance lease.

#### **Example 15: 2Deemed interest on interest-free loan**

Kiwi Co (a company resident in New Zealand) lends money to Beetle Co on interest-free terms and the laws of Country B allow Beetle Co to claim a deduction for tax purposes as if it had paid interest on the loan at a market rate.

NZ treats the loan as a debt instrument.

#### ***Question***

Whether the loan falls within the scope of the hybrid financial instrument rule in section FH 4?

*Answer*

The loan does not fall within the scope of the hybrid financial instrument rule because there is no payment under the loan that gives rise to a deduction for tax purposes in Country B. (Note that this example does not consider the application of the transfer pricing rules. If the transfer pricing rules apply to the loan, they may also treat Kiwi Co as earning income under the loan.)

#### **Example 16: Potential character mismatch**

Camel Co (a company resident in Country C) issues 10 year redeemable preference shares (RPS) to Kiwi Co (a company resident in New Zealand), which owns one hundred percent of the voting interests in Camel Co.

The RPS pay an annual return (dividend) that accrues daily and, to the extent accrued dividends are unpaid, forms part of the redemption price.

In Country C, the RPS are treated as debt for tax purposes and the coupons are ordinarily deductible as they accrue.

Country C does not have a tax rule equivalent to the primary rule for recommendation 1 of the OECD hybrid report.

*Question*

Whether the RPS fall within the scope of the hybrid financial instrument relating to character mismatches in section FH 4?

*Answer*

In New Zealand, the coupons would be assessable as dividend income because the exemption in section CW 9 for foreign dividends would not apply. Therefore, there is no D/NI mismatch arising from the RPS to counter.

#### *Timing mismatches*

Subsection (3) applies to timing mismatches. It applies to a payment under a financial instrument which does not have a duration, including extensions contemplated by the financial instrument, of three years or less.

Subsection (3) applies if the payment gives rise to assessable income, but the gap between the year in which the deduction is claimed by the payer in its country and the derivation of assessable income in New Zealand meets the requirements of subsection (7). An amount meets the requirements of subsection (7) if it is not included, or is not reasonably expected to be included, in income in New Zealand in an income year beginning within 24 months of the end of the accounting period in which it is deductible in the payer country.

### **Example 17:3 Prepaid interest**

Kiwi Co (a company resident in New Zealand) owns one hundred percent of the voting interests in Donkey Co (a company resident in Country D) and provides it with an interest-bearing loan for a fixed term of three years.

Donkey Co pays the interest upfront in a lump sum payment for which it is entitled to an immediate deduction in the foreign country.

Kiwi Co returns the interest payment on an accruals basis over the three-year term.

#### *Question 1*

Whether the loan falls within the scope of the hybrid financial instrument rule relating to timing mismatches in section FH 4?

#### *Answer 1*

The loan will not give rise to a timing mismatch under section FH 4(3) for Kiwi Co as it has a term of three years (limb (b)).

#### *Question 2*

Whether the answer changes if the loan is for a five-year term instead?

#### *Answer 2*

The loan will give rise to a timing mismatch under section FH 4(3). The portion of the interest income which under the financial arrangement rules in subpart EW would not be derived in or before the income year beginning 24 months after the end of the borrower's income year would be taxed upfront on receipt under section FH 4(4), instead of spread on an accruals basis under the financial arrangement rules in subpart EW.

### *Hybrid counteraction*

Subsection (4) is the main operative subsection for a character mismatch. It provides that a payment which is subject to the section gives rise to assessable income equal to the amount that would be assessable if the classification of the financial instrument were varied. Under subsection (6), this income is allocated to the year in which:

- in the case of a character mismatch, it would be derived if the terms of the instrument were varied so that the payment gave rise to income; or
- in the case of a timing mismatch, the payment is received.

### *Replacement payment under returning share transfer*

Subsection (5) provides for the case where a New Zealand taxpayer receives a replacement payment under a returning share transfer. Replacement payments are taxable income. However, if the returning share transfer is also a share lending arrangement as defined in section YA 1, the replacement payment can carry an imputation credit (section OB 64). If the share borrower is entitled to a deduction in its country for the replacement payment, the attachment of such a credit would give rise to a hybrid mismatch. In order to reverse this, the imputation credit is denied.

### ***Deductible foreign equity distribution definition***

The definition of “deductible foreign equity distribution” has been amended in section YA 1 to include distributions on shares in a foreign company for which a deduction against income or equivalent tax relief or tax benefit is allowed, or would be allowed in the absence of the hybrid mismatch legislation (including situations where the distribution is sourced directly or indirectly from an amount paid to the foreign company that is deductible). This means that the exclusion in section CW 9 for deductible foreign equity distributions will continue to apply to such distributions with priority over the hybrid mismatch rules of other countries, consistent with the OECD’s recommendation 2.1. For example, the adoption of hybrid rules in Australia will have no effect on the tax treatment of a New Zealand company in respect of a deductible dividend received from an Australian company.

# DISREGARDED HYBRID PAYMENTS AND DEEMED BRANCH PAYMENTS

## Sections FH 5 and FH 6

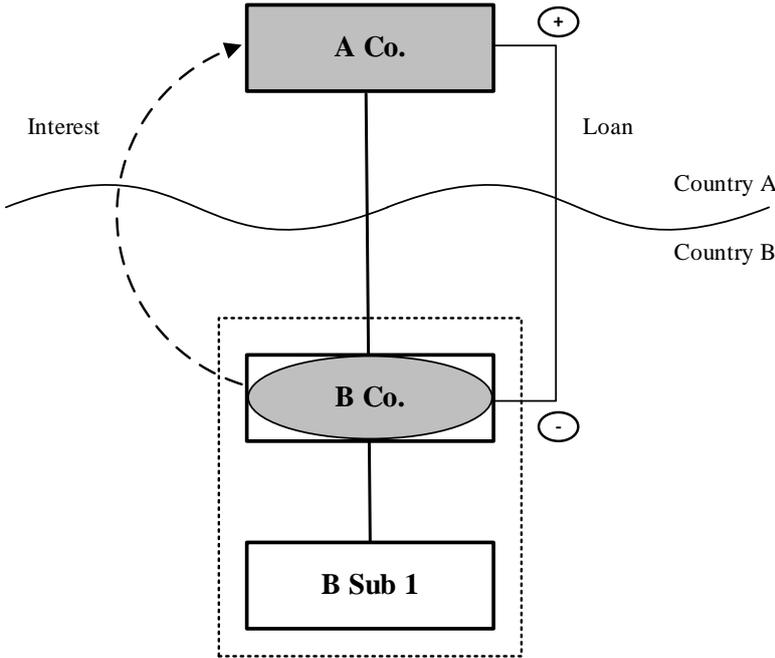
### Background

The disregarded hybrid payment rule is recommendation 3 of the OECD hybrid mismatch report. The deemed branch payment rule is recommendation 3 of the OECD branch mismatch report.

### Disregarded hybrid payments

The following diagram illustrates an example of a disregarded hybrid payment mismatch. Such mismatches always involve a payment by a hybrid entity.

A hybrid entity is an entity which is transparent for tax purposes in the country of an investor (Country A) but opaque for tax purposes in another country, generally where it is established (Country B). In the diagram below, B Co is the hybrid entity.



An interest payment from a hybrid entity (B Co) to its investor (A Co) will be deductible in Country B and disregarded in Country A. This results in a D/Ni hybrid mismatch. The mismatch results in double non-taxation if B Co groups its tax loss with the income of another entity (B Sub 1 in the example) whose income is not taxable in Country A.

### Deemed branch payments

The same outcome can arise if B Co is instead a branch of A Co in Country B and is entitled in Country B to a deduction for a charge made to it by A Co, if that charge is not also recognised in Country A.

## Summary of legislative response

Sections FH 5 and FH 6 identify amounts of expenditure relating to:

- payments that are deductible in the country of the payer and are disregarded in the country of the payee due to the status of the payer; and
- mismatches in the deductibility and recognition of charges by a head office to a branch in another country which are recognised for tax purposes in the branch country, generally as a way of a branch country ensuring that it taxes only that portion of a multinational entity's income that corresponds to the activities undertaken in the branch country. These charges are only subject to the sections to the extent they do not reflect a simple allocation of actual third party costs. For example, these sections would apply to a profit margin charged by head office to a branch, or a charge for some internally-performed function.

Section FH 5 applies where the deduction is in New Zealand, whereas FH 6 applies where New Zealand is not including a payment (or deemed payment) as income and the payment (or deemed payment) is deductible in another country.

These identified amounts are treated as non-deductible under FH 5 or are included as assessable income under FH 6. A deduction for them is provided under section FH 12 to the extent they do not exceed surplus assessable income under the offsetting rule in that section.

## Application date

The rules apply to income years beginning on or after 1 July 2018. Section FH 5 applies to payments for which deductions are claimed in that income year or subsequently. Section FH 6 applies only to payments that are paid on or after the start of the payee's income year.

## Detailed analysis

### *Section FH 5 – primary rule*

Section FH 5 is the primary rule for recommendation 3 of the OECD hybrid mismatch report and recommendation 3 of the OECD branch mismatch report. It applies with priority over the defensive rules of foreign countries.

The primary rule concerns New Zealand residents and New Zealand branches of non-residents that incur an amount of expenditure relating to disregarded hybrid payments, or a charge relating to deemed branch payments.

Subsection (1) sets out the conditions that must be satisfied for the primary rule to apply. They are that:

- there must be an amount of expenditure relating to either a disregarded hybrid payment under subsection (2) or a deemed branch payment under subsection (3);
- the payment or charge is not assessable income to the recipient in New Zealand;
- the expenditure or charge is deductible in New Zealand;

- the payment or charge is treated as not being received in a foreign country due to the status of the payer;
- the payment or charge would be treated as received in a foreign country if the tax status of the payer were different;
- the payment or charge does not give rise to tax under CFC rules in a foreign country.

For the primary rule to apply to a disregarded payment, subsection (2) must be satisfied in addition to (1). Subsection (2) requires that the payer (who can be a New Zealand resident or a branch of a non-resident) either makes a payment to another person in the same control group or makes the payment under a structured arrangement. This requirement is set out separately because it is not necessary for the deemed branch payments context.

For the primary rule to apply to a deduction claimed by a New Zealand branch for a charge paid to a non-New Zealand part of the same legal entity (deemed branch payments) the charge must satisfy the requirements of subsection (1) and some further requirements set out in subsection (3). The purpose of these requirements is to distinguish deduction for allocation of third party expenditure (which are dealt with by section FH 9) from true intra-entity charges.<sup>4</sup>

Where the relevant conditions are met, the payer of the payment is denied a deduction for all expenditure (including foreign exchange gains and losses) relating to the payment, under subsection (4). However, under section FH 12, if the payer has surplus assessable income the mismatch amount may be set off against that amount.

**Example 18: Disregarded hybrid payment mismatch (primary rule)**

Jefferson Co, a foreign company resident in Washington Country (a foreign jurisdiction) owns one hundred percent of Hamilton Co, an unlimited liability company resident in New Zealand. Jefferson Co. provides Hamilton Co with a foreign currency loan under which interest is payable annually. In the relevant income year, the foreign currency strengthens relative to the New Zealand dollar.

The interest payments and any foreign currency movements on the loan are deductible (before applying the hybrid rules) to Hamilton Co in New Zealand. The laws of Washington Country allow Jefferson Co to treat Hamilton Co's income and expenditure as attributable to Jefferson Co because of Hamilton Co's unlimited liability. This means that the interest payment is disregarded in Washington Country due to the status of the payer (Hamilton Co). If Hamilton Co were treated differently, for example if it were treated as a separate entity in Washington Country, the interest payment would be treated as received by Jefferson Co.

Under section FH 5(5), Hamilton Co has a mismatch amount for its incurred expenditure on the debt instrument. This expenditure is non-deductible under section FH 5(4). Hamilton Co would have to apply section FH 12 to determine whether a deduction can be claimed.

<sup>4</sup> See paragraphs 85-88 of the OECD Branch Mismatch Report for a fuller discussion of the difference between deductions for allocation of third party expenditure and true intra-entity charges.

### **Example 19: 4Deemed branch payment mismatch (primary rule)**

Root Co, a foreign company resident in Ashes Country (a foreign jurisdiction) operates through a branch in New Zealand. Root Co manufactures cricket bats in Ashes Country, and sells them to retail stores in various countries, generally via branches of Root Co in those countries, including the one in New Zealand. Root Co transfers its cricket bats from Ashes Country to its branch in New Zealand. Each cricket bat transfer is compensated for tax purposes by a \$250 charge from the branch to Root Co representing \$150 of costs per cricket bat to Root Co as well as a \$100 arm's length mark-up in recognition of the profit generating activities of the manufacturing process in Ashes Country. This \$100 mark-up is approximately the same as the marginal profit Root Co receives upon selling a cricket bat in Ashes Country.

Currently, the entirety of the \$250 charge is deductible to Root Co's branch in New Zealand and can be offset against income earned by the branch for cricket bat sales. Ashes Country exempts active branch income from taxation.

The \$250 is potentially within scope of proposed section FH 5 as a deemed branch payment.

The \$150 cost component of the charge is not within scope of section FH 5. This is because it does not satisfy proposed section FH 5(3)(b) due to the amount being determined by reference to the actual costs of Root Co. (though this amount may be subject to proposed section FH 9). However, the \$100 arm's length mark-up component of the charge meets the requirements of section FH 5(3)(b) as it is a profit-based amount and so it is not determined by reference to any payments made by Root Co. or any other person in a control group with Root Co.

To the extent that the \$100 mark up portion of the transfer price for each bat is not treated as income of Root Co. in Ashes Country, it will be denied a deduction under section FH 5(4). It will also be a mismatch amount under FH 5(5) until there is surplus assessable income against which it may be set off under section FH 12.

### ***Section FH 6 – defensive rule***

Section FH 6 is the defensive rule for recommendation 3 of the OECD hybrid mismatch report. It also applies as a defensive rule for recommendation 3 of the OECD branch mismatch report, though the report does not recommend a defensive rule.

The defensive rule mirrors the primary rule and is targeted at payments that are:

- deductible to a foreign entity but disregarded in New Zealand; and
- foreign branches of New Zealand persons who are entitled to a deduction in another country for a deemed branch payment or charge.

Subsection (1) of section FH 6 sets out the requirements for the defensive rule to apply:

- a non-resident, or foreign branch of a New Zealand resident, must be treated by the relevant foreign country as having made a payment (a disregarded hybrid payment) meeting the requirements of subsection (2) to a person in New Zealand or having incurred a deemed branch payment meeting the requirements of subsection (3);
- the relevant foreign country allows the payer a deduction for the payment or equivalent tax relief;
- the relevant foreign country does not have hybrid mismatch legislation corresponding to section FH 5 (the primary rule) that applies to the payer and the charge for any part of the relevant year (in that case, the foreign country's primary rule would take priority);
- the person in New Zealand does not derive assessable income from the payment;

- the payment would result in assessable income for the person in New Zealand if:
  - in the case of a hybrid mismatch, the tax status of the payer were different. New Zealand tax law does not generally provide for foreign entities to be entirely disregarded. Even if they are fiscally transparent, such as partnerships, a payment by the entity to a member is generally taken account of for tax purposes (albeit that inclusion by the member of the payment may be largely offset by attribution to the member of a share of the deduction – this means the payment is potentially subject to section FH 9). One case where a payment can be disregarded in this way is where it is made by one member of a tax consolidated group to another member – see section FM 8(2); or
  - in the case of a branch mismatch, the payer and payee were separate persons; and

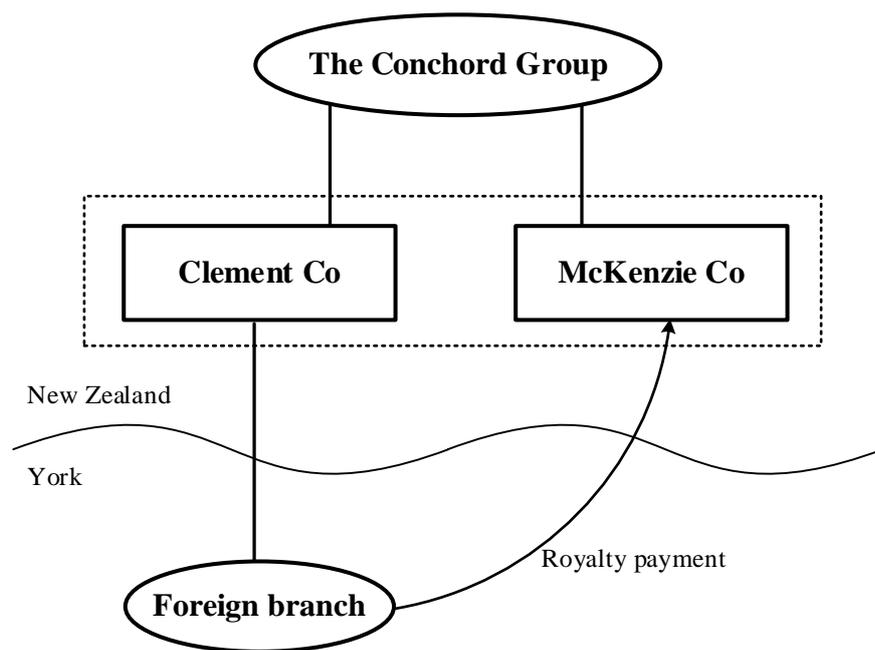
For the defensive rule to apply to a disregarded payment, subsection (2) must be satisfied in addition to (1). Subsection (2) requires that the relevant parties are a payee in New Zealand that is in the same control group as the payer (who can be a non-resident or a foreign branch of a New Zealand resident) or that the payment is made under a structured arrangement.

For the defensive rule to apply to a deemed branch payment from a foreign branch of a New Zealand person, that charge must satisfy the requirements of subsection (1) and some further requirements set out in subsection (3). As with section FH 5(3), the purpose of these requirements is that section FH 6 should only apply to a mismatch arising because of an intra-group charge deduction in a foreign country being unmatched by income in New Zealand. Section FH 8 is intended to apply to double deductions arising due to the allocation of the same expenditure to two countries.

Where the conditions referred to above are met, the amount of the payment or charge is assessable income (it is treated as being zero, if the payment or charge gives rise to a loss, for example, due to foreign exchange fluctuations), under subsection (4). This assessable income is derived in the year in which it would be derived if the payer and payee were separate persons or the payer's tax status was different, under subsection (5). The assessable income is further treated as a mismatch amount under subsection (6), which can be reversed if the taxpayer has surplus assessable income under section FH 12 to offset against it.

Subsection (7) prevents a mismatch amount under subsection (5) from being carried forward if the payer country introduces hybrid mismatch legislation corresponding to the primary rule for disregarded hybrid payment and/or deemed branch payment mismatches.

**Example 20: New Zealand consolidated group and disregarded hybrid payment**



McKenzie Co and Clement Co are two companies resident in New Zealand in the entertainment business. They are both part of a consolidated group (the Conchord group) under New Zealand law. Clement Co has a branch in York, a foreign country that does not have hybrid rules.

Clement Co makes a royalty payment to McKenzie Co through its foreign branch. Under the laws of York, Clement Co is entitled to a deduction for the payment. Under New Zealand's consolidation rules in subpart FM, the payment is treated as excluded income for McKenzie Co with no deduction for Clement Co.

The counterfactual test in FH 6(1)(d) is satisfied because if Clement Co's tax status were changed such that it is no longer consolidated with McKenzie Co, the payment would be assessable income for McKenzie Co. McKenzie Co must include the royalty payment as assessable income. This amount is a mismatch amount and may give rise to a deduction under section FH 12 if there is an amount of surplus assessable income that can be used to offset the amount.

# REVERSE HYBRID RULE AND BRANCH PAYEE MISMATCH RULE

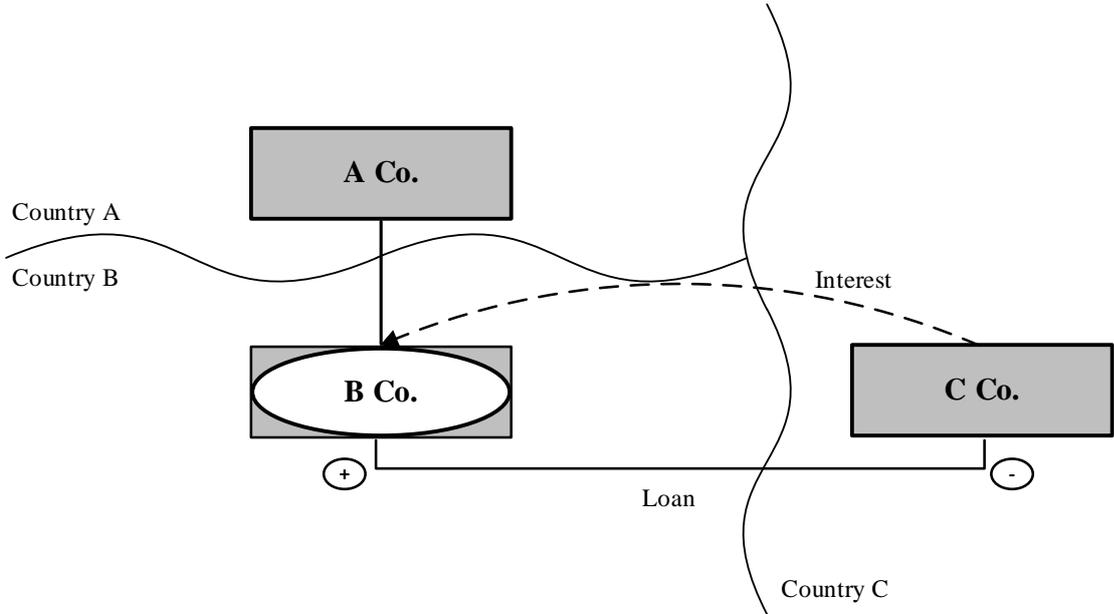
## Section FH 7

### Background

Section FH 7 implements recommendation 4 of the OECD hybrid mismatch report, denying a deduction for a payment to a reverse hybrid in certain cases. It also implements recommendation 2 of the OECD branch mismatch report, denying a deduction for a payment which is not taxed due to a branch mismatch in certain cases.

The following diagram illustrates an example of a reverse hybrid mismatch. Such mismatches always involve a payment to a reverse hybrid entity.

A reverse hybrid entity is opaque for tax purposes in the country of an investor (Country A) but transparent for tax purposes in another country, generally where it is established (Country B). In the diagram below, B Co is the reverse hybrid.



If B Co receives a payment that is deductible for the payer (C Co), that payment may not be taxed in Country A or Country B. This is because Country B views the payment as being earned by A Co, while Country A views the payment as being earned by B Co. If the payment would have been taxable had it been made directly from C Co to A Co, this is a deduction/no inclusion (D/NI) hybrid mismatch outcome.

A similar outcome can arise as a result of a branch payee mismatch. For example, if the diagram above is modified so that there is no B Co but:

- Country A treats C Co.’s payment as received by a Country B branch of A Co, and exempts it under a territorial approach to active income; and

- Country B does not recognise the payment as received by a permanent establishment in Country B,

the result will be that the payment by C Co is deductible in Country C, but not taxed anywhere due to the different allocation rules in Countries A and B, which is once again a D/NI mismatch.

### **Application date**

Section FH 7 applies to deductions claimed in income years beginning on or after 1 July 2018.

### **Detailed analysis**

Section FH 7(1) denies a deduction for expenditure relating to a payment:

- to a person who exists under the law of another country (the payee country). This requirement assumes that the person is not a natural person, and owes their existence to the laws of a particular country. For example, in the case of a company, the company must be formed or otherwise owe its existence to a particular country's laws;
- where the expenditure would be allowed as a deduction for the payer in the absence of the hybrid rules;
- treated in the payee country as either:
  - received in another country. This will be the case where there is a potential branch mismatch. A branch mismatch requires that the payee treats the payment as attributable to operations outside its residence country; or
  - income of another person in the same control group as the payer. This will be the case where there is a potential reverse hybrid mismatch. The payee country treats the reverse hybrid as fiscally transparent, so that the payment is treated as the income of its owners. The requirement is only met in the case of an owner who is in the same control group as the New Zealand payer;
- where the payee and payer are also in the same control group, or the payment is made under a structured arrangement;
- where the payment is not subject to taxation of a person in the same control group as the payee. This will be the case where:
  - in the case of a potential branch mismatch, the branch country does not tax the payment;
  - in the case of a reverse hybrid, the owner country does not tax the payment;
- the payment would have been taxable if it were made:
  - in the case of a branch mismatch to the payee directly in the payee country;
  - in the case of a reverse hybrid, directly to the owner.

If these requirements are met, section FH 7(2) denies a deduction for the payment and any related expenditure from foreign currency movements (which would be included as part of 'interest' expenditure under the financial arrangement rules in subpart EW).

**Example 21: 5Diverted branch payment mismatches**

Pavlova Co (a company resident in New Zealand) makes a deductible payment to the foreign branch of a group member, Banana Cake Co (which is incorporated and resident in Country B).

The domestic law of Country B (the payee country) exempts foreign branch profits and considers the payment to have been paid to the foreign branch of Banana Cake Co.

In Country C, Banana Cake Co is recognised as having a permanent establishment (PE) but the payment is regarded as having been paid to Banana Cake Co in its own right, instead of being allocated to the PE.

The payment is therefore not subject to income tax in either Country B or Country C. The payment thus meets the requirements of section FH 7(1)(a), (b), (c), and (d).

The counterfactual requirement in section FH 7(1)(e) is also met as the payment would have been subject to income tax in Country B had it been treated as a payment to Banana Cake Co's head office in Country B.

As the requirements in Section FH 7(1) are satisfied, subsection (2) denies Pavlova Co a deduction for its payment to Banana Cake Co.

**Example 22: Disregarded branch payment mismatches**

The facts are the same as in example 21, except that Banana Cake Co is not regarded as having a PE in Country C. Country B still considers that there is a PE in Country C.

This mismatch therefore satisfies each of the requirements of Section FH 7(1) in the same way as the diverted branch payment example above. Pavlova Co will similarly be denied a deduction under subsection (2) for its payment to its group member Banana Cake Co.

# DEDUCTIBLE HYBRID AND BRANCH PAYMENTS (DOUBLE DEDUCTIONS) RULE

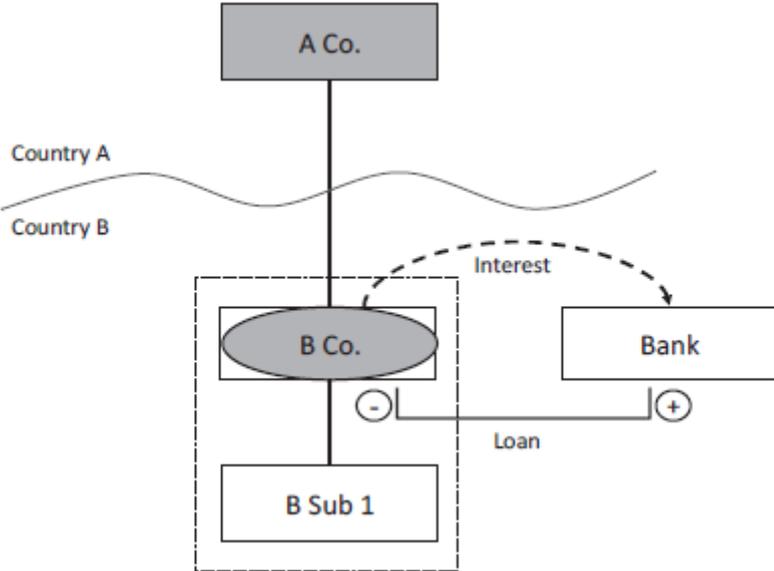
## Sections FH 8 and FH 9

### Background

The deductible hybrid rule is recommendation 6 of the OECD hybrid mismatch report and the branch payments rule is recommendation 4 of the OECD branch mismatch report.

The following diagram is an example of a deductible hybrid payments mismatch. Such mismatches always involve a payment from a hybrid entity.

Hybrid entities are treated as transparent under the laws of the investor’s tax country and opaque under the laws of the establishment or operating country. This hybrid treatment can result in the same item of expenditure incurred by the hybrid being deductible under the laws of both the parent and payer countries.



In the example, B Co is a wholly-owned subsidiary of A Co. B Co is disregarded for Country A tax purposes. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is disregarded, A Co is treated as the borrower under the loan under Country A’s tax laws. The arrangement therefore results in an interest deduction under the laws of both Country B and Country A (unless Country A denies a deduction for some reason, for example under an active foreign income exemption).

B Co is consolidated for tax purpose with its operating subsidiary (B Sub 1), which allows it to utilise the tax benefit of the interest deduction to B Sub 1. The ability to utilise the tax benefit through the consolidation regime allows the two deductions for the interest expense to be offset against separate income arising in Country A and Country B. This is a double deductions (DD) mismatch.

Branch structures can also achieve the same result, particularly if the country where the entity with the branch is resident in a country that taxes the branch income (as New Zealand does).

## **Summary of legislative response**

Sections FH 8 and FH 9 implement recommendation 6 of the OECD hybrid report and recommendation 4 of the OECD branch report. They are respectively primary and defensive rules designed to deal with hybrid and branch payment mismatches which produce double deduction (DD) outcomes.

The primary rule applies where the hybrid entity or branch is owned by a New Zealand resident and located in a foreign country, whereas the defensive rule applies where the hybrid entity or branch is in New Zealand and owned by a person in another country. The primary rule applies with priority over the defensive rules of foreign countries.

Notably, the primary rule's application is restricted. Only foreign branches or hybrid entities that are capable of offsetting their losses against the income of an existing foreign (non-hybrid) entity are within scope of the rule. This means that simple offshore structures, such as a New Zealand company with only a foreign branch in a country are excluded from the rule. The primary rule also contains a transitional rule that ensures that a person that transitions into the scope of the rule will not benefit from the restricted scope in relation to previous year foreign losses.

The effect of these provisions is to identify gross amounts of expenditure relating to a person's branch or hybrid entity. These identified amounts are non-deductible in New Zealand unless they can be offset against surplus assessable income under section FH 12 (see below).

## **Application date**

The rules apply to income years beginning on or after 1 July 2018.

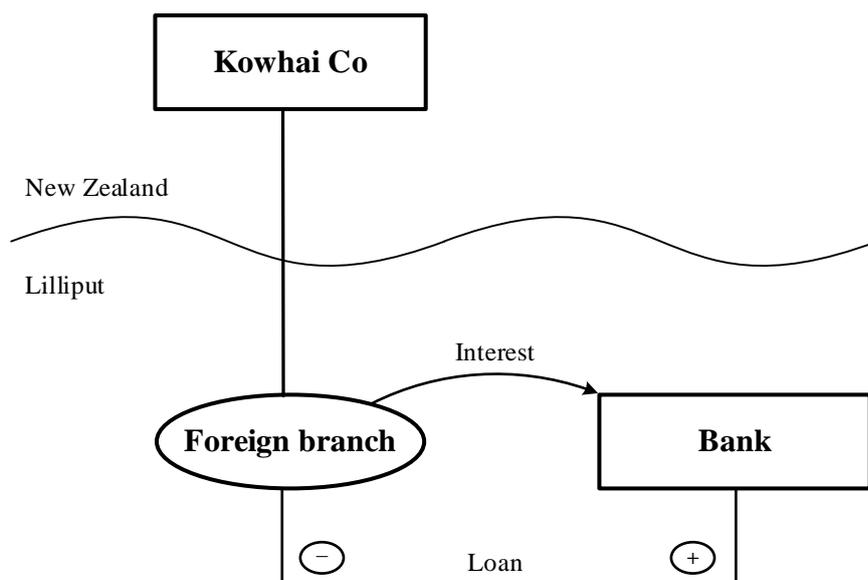
## **Detailed analysis**

### ***Section FH 8 (primary rule)***

New Zealand residents that are related to a foreign hybrid entity or have a foreign branch may fall within the scope of this rule.

The key requirement for the rule to apply is in sections FH 8(1)(a) and FH 8(1)(b) which together mean the section only applies if the relevant foreign country allows losses of the hybrid entity/branch to be offset against income of an existing person whose income is not taxed in New Zealand (other than that which is sourced in New Zealand). This is generally referred to as non-dual inclusion income in the OECD hybrid and branch mismatch reports, and is income which is not surplus assessable income under the new legislation.

**Example 23: New Zealand company with simple foreign branch structure**



Kōwhai Co, a company resident in New Zealand, sells native wood carvings in New Zealand and in Lilliput (a foreign country). Kōwhai Co conducts its Lilliput business through a branch in that country. Kōwhai Co borrows from a bank to support its activities in Lilliput. This loan is attributed to its Lilliput branch.

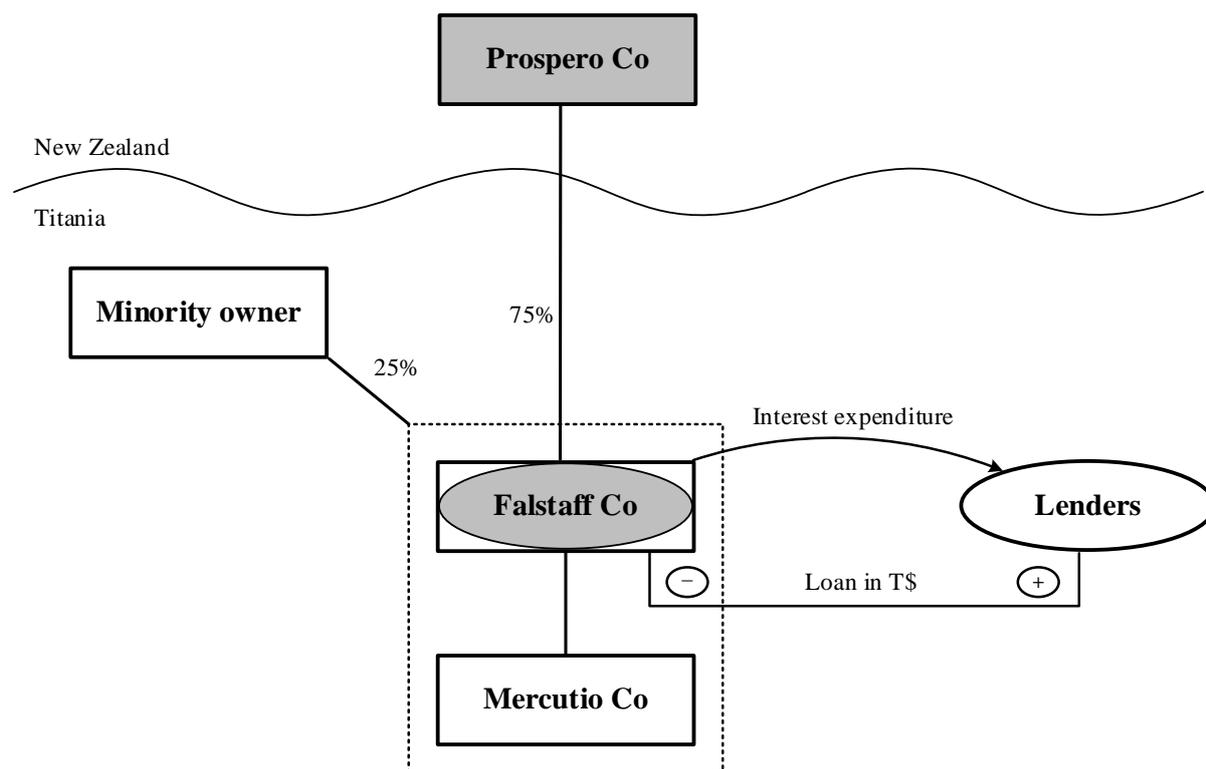
As New Zealand taxes its residents on their worldwide income, Kōwhai Co will be entitled to a deduction in New Zealand for interest paid on the loan. The interest expenditure will also be deductible in Lilliput for Kōwhai Co's branch.

FH 8(1)(a) is not satisfied as Kōwhai Co has not used the income of another person or entity) to offset against its Lilliput branch interest expenditure (there is no such person or entity).

Accordingly, Kōwhai Co's New Zealand tax position has not been altered by the introduction of hybrid and branch mismatch rules. However, a rule equivalent to section FH 9 (the defensive rule for double deductions in hybrid entities and branches) in a foreign country may have an impact on Kōwhai Co's foreign tax affairs.

Section FH 8(2) denies a New Zealand person a deduction for the expenditure it incurs through the hybrid entity or branch. This expenditure is treated as a mismatch amount that can be offset (that is, deducted) to the extent there is surplus assessable income under section FH 12.

### Example 24: Foreign hybrid entity structure



The Globe group consists of Prospero Co, Falstaff Co and Mercutio Co. Prospero Co, a company resident in New Zealand, owns seventy five percent of Falstaff Co, a hybrid entity resident in Titania (a foreign country). Falstaff Co is treated as a company in Titania, but is treated for New Zealand tax purposes as a partnership. Its income and expenditure is thus attributed to its owners (Prospero Co and the twenty five percent minority owner). Falstaff Co owns one hundred percent of Mercutio Co, a company resident in Titania, and the two entities are consolidated. The consolidation regime of Titania allows the losses of one entity to be offset against the income of the other. Mercutio Co is treated for New Zealand tax purposes as a company, and undertakes an active business in Titania, such that its income is not attributed to Prospero Co under the CFC regime.

Falstaff Co performs a financing function for the Globe Group, and its financing costs are deductible in Titania which means that it regularly makes tax losses in Titania. The financing expenditure is also attributed to Prospero Co under New Zealand law, and Prospero Co claims deductions for its seventy five percent share of that expenditure. Because Falstaff Co borrows in Titanian dollars, fluctuations in the NZ\$/T\$ exchange rate mean the amount of its deductions attributed to Prospero Co under New Zealand tax rules can be much larger or smaller than the amount calculated for Titanian tax purposes.

Prospero Co satisfies section FH 8(1) due to the ability of its related hybrid entity Falstaff Co to offset its losses against the income of Mercutio Co, which is not generally assessable in New Zealand under the CFC regime. Under sections FH 8(2) and (3), Prospero Co has a denied deduction and mismatch amount equal to its expenditure from Falstaff Co. There is no need to compare the amount of this expenditure with the amount of expenditure Falstaff Co calculates for Titanian tax purposes.

If Mercutio Co were a partnership, so that its income was subject to New Zealand tax in the hands of Prospero, section FH 8(1) would not apply, and no deduction for the financing costs would be denied to Prospero under section FH 8.

A person that is outside the scope of section FH 8(1) because its foreign hybrid or branch is not able to set off expenditure or loss against another person's non-dual inclusion income and then falls within the scope of the subsection due to a change of group structure (for example, the acquisition of a new non-hybrid entity in the same country as the hybrid entity) is subject to the rule on a prospective basis and also must consider subsections (4) and (5) of section FH 8. These provisions function as a transitional rule for persons in such a situation to reverse

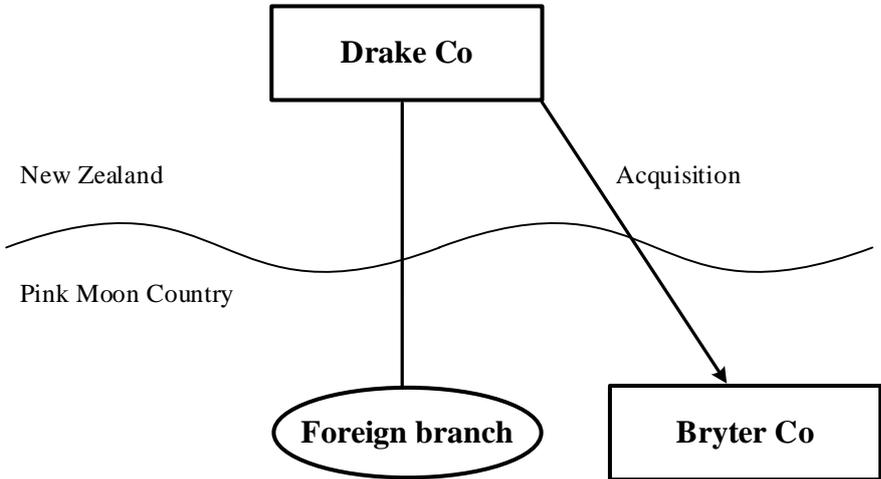
their historic foreign hybrid or branch losses if they become usable in the other country in a way that would defeat the integrity of the primary rule.

This transitional rule only applies if:

- the person was related to a foreign hybrid entity or had a foreign branch prior to subsection (1) applying to the person; and
- the laws of the relevant foreign country allow accumulated losses of the hybrid entity or branch to be set off against income that is not assessable in New Zealand under the new structure.

To the extent those requirements are met, section FH 8(5) treats the net loss of the hybrid entity or branch as assessable income and a mismatch amount.

**Example 25: New Zealand company with foreign branch making acquisition**



Drake Co, a company resident in New Zealand, has for many years sold guitars in Pink Moon Country (a foreign country) through a branch. In the last two years trading conditions have been poor in Pink Moon Country and the branch has made losses. These losses accumulate in Pink Moon Country and can also be offset against Drake Co.'s assessable income from other activities. Drake Co has had no other activities or interests in Pink Moon Country.

Drake Co does not satisfy the section FH 8(1)(a) and section FH 8(1)(b) requirements because the branch losses cannot be offset against the income of an entity that is not taxable in New Zealand.

However, Drake Co believes its prospects in Pink Moon Country will improve, and has now decided to expand its operations there by acquiring Bryter Co - a company resident in Pink Moon Country that sells pianos and has a profitable track record. Bryter Co is treated as a company for New Zealand tax purposes.

The tax laws of Pink Moon Country allow Drake Co. to group its Pink Moon branch operation losses with Bryter Co profit such that its future branch losses can be offset against the income of Bryter Co. Drake Co must now apply section FH 8 to any future branch losses; they will become non-deductible mismatch amounts under sections FH 8(2) and (3). The laws of Pink Moon Country have no rules preventing the branch losses of Drake Co accumulated before the Bryter Co acquisition being carried forward and offset against Bryter Co income post-acquisition. Drake Co meets the requirements of FH 8(4) and so must apply section FH 8(5) and include as assessable income the accumulated Pink Moon Country branch losses (as calculated for New Zealand tax purposes) in its New Zealand income in the income year of the Bryter Co acquisition.

### ***Section FH 9 (defensive rule)***

The defensive rule mirrors the primary rule. It applies to a foreign resident operating in New Zealand through a branch or a New Zealand hybrid entity in the same control group as a foreign resident. The defensive rule does not apply where the country of that foreign resident has enacted hybrid mismatch legislation corresponding to the primary rule.

The rule applies when expenditure of the hybrid entity/branch is deductible in New Zealand and the country of the foreign resident also allows that expenditure as a deduction for the foreign resident.

Section FH 9(2) denies a deduction for the expenditure incurred in New Zealand, and section FH 9(3) treats the denied deduction as a mismatch amount unless and until it is set off against surplus assessable income under section FH 12.

#### **Example 26: 6Foreign-owned hybrid entity resident in New Zealand**

Jefferson Co, a foreign company resident in Washington Country (a foreign jurisdiction) owns one hundred percent of Hamilton Co, an unlimited liability company resident in New Zealand. Hamilton Co is a hybrid entity.

Hamilton Co incurs various expenses in carrying out its business. These expenses are deductible in New Zealand and are also treated as deductible against the income of Jefferson Co under the tax laws of Washington Country. Washington Country has not enacted hybrid rules.

Under sections FH 9(2) and FH 9(3), Hamilton Co has a denied deduction and mismatch amount for its incurred expenditure. This expenditure will be non-deductible, except as provided for in section FH 12. This denial is intended to ensure that the expenses incurred by Hamilton Co cannot be used to offset income which is taxable in New Zealand but is not taxable to Jefferson Co in Washington Country.

A mismatch amount under subsection (3) cannot be carried forward and deducted under section FH 12 if the foreign country introduces hybrid mismatch legislation corresponding to the primary rule for deductible hybrid and branch payment mismatches.

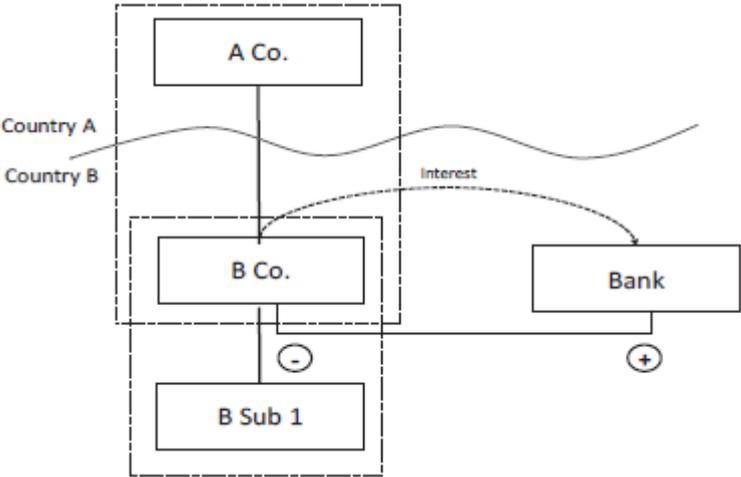
# DUAL RESIDENT PAYER RULE

## Section FH 10

### Background

The dual resident payer rule is recommendation 7 of the OECD hybrid mismatch report. It is similar to recommendation 6 of the OECD hybrid mismatch report in that it deals with a single payment that is deductible in two countries. However, in this case, there is only one entity (a company) involved, which both countries treat as tax resident and can lead to double deduction (DD) mismatches.

The diagram below illustrates an example of a dual resident payer mismatch.



In the example, B Co (a company incorporated in Country B but tax resident in both Country A and Country B) is a wholly-owned subsidiary of A Co (a company incorporated and tax resident in Country A). B Co owns the shares in B Sub 1 (also incorporated and tax resident in Country B). B Co is consolidated for tax purposes with A Co (under Country A law) and B Sub 1 (under B Country law).

Similar to the deductible hybrid payment example above, B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is resident in both Country A and Country B it is subject to tax on its worldwide income in both countries on a net basis and can utilise any net loss under the tax consolidation regimes of both countries to offset income of other resident companies. This creates the potential for the two deductions for the interest expense to be set off against separate income arising in Country A and Country B.

### Summary of legislative response

Section FH 10 implements recommendation 7 of the OECD hybrid mismatch report. It deals with companies that are resident in two countries and which produce double deduction (DD) outcomes by denying the deduction in New Zealand (noting that the other country will also deny the deduction if they have an equivalent to recommendation 7). The deduction denied will be treated as a mismatch amount until there is surplus assessable income under section FH 12.

New Zealand tax law already prevents a dual resident company from grouping its losses or being a member of a tax consolidated group, which are two ways that dual resident company losses can be offset against income that is not taxed in both countries. This rule will more thoroughly prevent this outcome by removing the ability of a dual resident company to offset its expenditure against income earned through a reverse hybrid, such as (potentially) a New Zealand limited partnership.

### **Application date**

The rule applies to income years beginning on or after 1 July 2018.

### **Detailed analysis**

Section FH 10(1) provides that the rule applies to a company that is a New Zealand resident and is liable to tax in another country due to its domicile, residence or place of incorporation.

Section FH 10(2) states that a company meeting the requirements of subsection (1) is denied a deduction for all of its expenditure. The deduction denied is a mismatch amount under section FH 10(3). Such a company must then consider whether there is any surplus assessable income under section FH 12 to determine whether the denial can be reversed. Generally, the two sections will interact by allowing the expenditure to be offset against the income of the company, less any income that is not and will not be included in the other country that the company is resident in. This might include:

- income earned through a New Zealand limited partnership, if the other residence country treats the limited partnership as a country for its tax purposes;
- income earned in a foreign branch, if the other country has a foreign branch exemption.

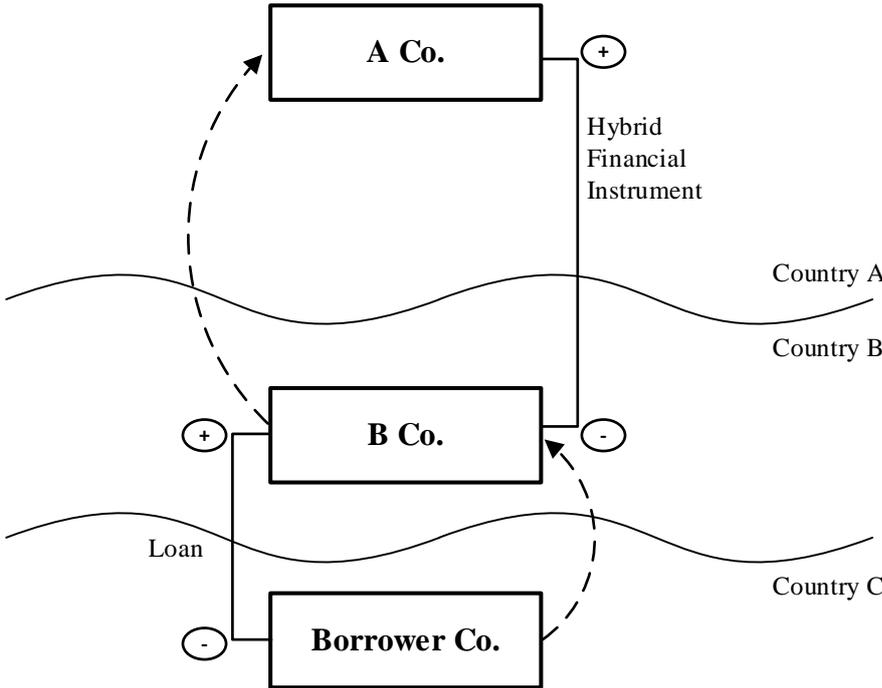
# IMPORTED MISMATCH RULE

## Section FH 11

### Background

The imported mismatch rule is recommendation 8 of the OECD hybrid mismatch report and recommendation 5 of the OECD branch mismatch report.

An imported mismatch occurs when a payment that does not directly result in a hybrid mismatch outcome funds another payment that does result in a hybrid mismatch outcome. The illustration below is an example of an imported mismatch.



The imported mismatch here occurs between B Co and Borrower Co. Borrower Co gets a deduction for its payment and B Co includes that payment as taxable income, meaning there is no direct hybrid mismatch on that payment. However, that payment is used to fund the payment on a hybrid financial instrument from B Co to A Co. Assuming neither Country A nor Country B has hybrid rules, this payment results in a deduction for B Co., but no corresponding income inclusion for A Co. The loan between Borrower Co and B Co. then ‘imports’ the hybrid mismatch back to Country C, where there is a resulting indirect deduction/no inclusion (D/NI) hybrid mismatch.

### Summary of legislative response

Section FH 11 implements recommendation 8 of the OECD hybrid mismatch report and recommendation 5 of the OECD branch mismatch report.

Section FH 11 denies a deduction for a payment (the imported mismatch payment) which does not itself give rise to a hybrid or branch mismatch, but which is treated as funding such a

payment (the funded payment). Imported mismatch payments are split into payments where the imported mismatch payment and the funded payment are part of an arrangement (a structured arrangement) and those where they are not.

## **Application date**

Section FH 11(3), which denies a deduction for an imported mismatch payment which is part of a structured arrangement, applies to payments made in income years beginning on or after 1 July 2018. Deductions for other imported mismatch payments (unstructured imported mismatches) are not denied until income years beginning on or after 1 January 2020.

## **Detailed analysis**

### ***General***

The imported mismatch rule in section FH 11 prevents taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore hybrid mismatch into New Zealand through the use of a non-hybrid instrument such as an ordinary loan.

In brief, the imported mismatch rule denies deductions for a broad range of payments, including interest, royalties, rents and payments for services, if the income from such funds is offset, directly or indirectly, against a payment that arises under a hybrid mismatch arrangement in a foreign country. This means that the hybrid or branch mismatch will be between two foreign countries, rather than between New Zealand and a foreign country, but there will be a deductible payment in New Zealand that is helping fund the hybrid or branch mismatch payment.

### ***Conditions***

Subsection (1) provides that the imported mismatch rule applies where there is a person that makes a payment (the funder) to another person in a foreign country that does not have the hybrid and branch mismatch rules corresponding to subpart FH and which:

- directly or indirectly funds a hybrid or branch mismatch payment. In order for the funded payment to be a hybrid mismatch payment, it must be between two non-residents who do not have hybrid or branch mismatch rules that counteract the mismatch (paragraphs (a), (d) and (e));
- is otherwise deductible to the funder (paragraph (b)); and
- is:
  - made under a structured arrangement; or
  - funds a hybrid mismatch between two persons (the payer and the payee) where the payer is in the same control group as the funder (paragraph (c)).

### ***Structured and unstructured imported mismatches***

The amount of the deduction denied to the funder depends on whether the payment is made under a structured arrangement or not. The definition of a structured arrangement is the

definition used for the hybrid rules generally (discussed above). A structured arrangement can exist between control group members. For example if funds are provided by a foreign parent to a New Zealand borrower via a series of consecutive intra-group funding transactions, and a transaction in that series gives rise to a hybrid mismatch, it is highly likely that the loan to the New Zealand borrower is part of a structured arrangement. Interest on the loan is subject to denial under section FH 11.

In determining whether or not a payment is made under a structured arrangement, it is not relevant when the arrangement was entered into, only when the payment is made. For example, suppose that in 2010, a multinational group set up a structure which gave rise to a hybrid mismatch not involving New Zealand, but where payments from New Zealand funded a part of the hybrid mismatch payment. A payment made as part of such a structure by a New Zealand person in a tax year beginning on or after 1 July 2018 will be subject to section FH 11.

If the payment is under a structured arrangement, the amount of the denial is given by subsection (3). It is the amount of the deduction, limited to the amount of the funded payment for which a deduction would be disallowed to the payer of the hybrid mismatch payment if hybrid mismatch legislation applied to that person.

If the payment is not under a structured arrangement, the amount denied is the amount that can fairly and reasonably be treated as providing funds for the funded payment giving rise to a hybrid mismatch under subsection (4). Subsection (5) provides that this amount should be determined consistently with the approach used in chapter 8 of the OECD hybrid mismatch report.

### ***OECD imported mismatch approach***

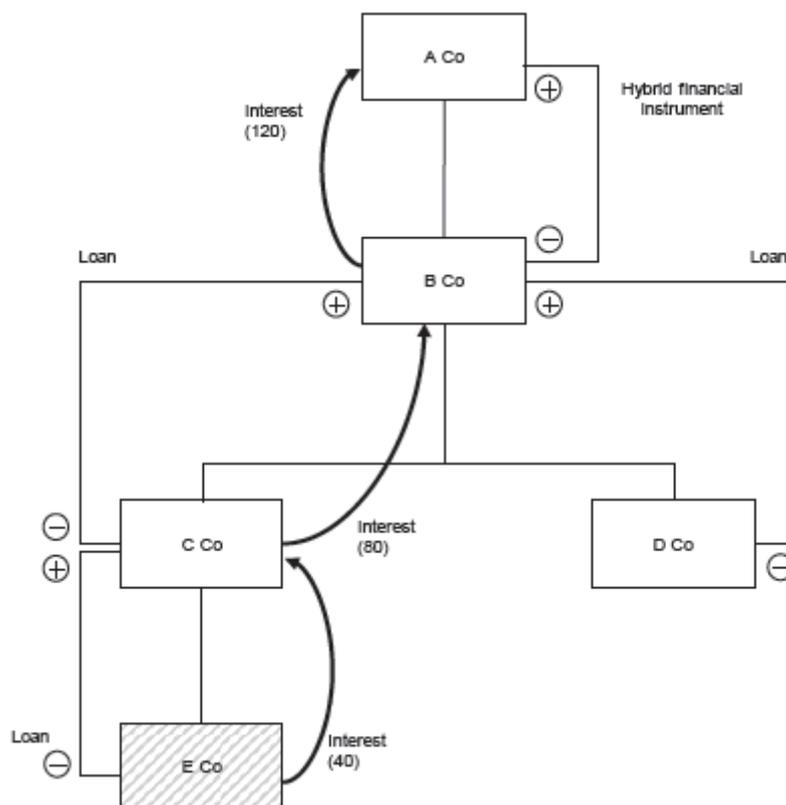
One of the complexities with the imported mismatch rule arises because there may be multiple countries (including New Zealand) with deductible payments that are helping fund the hybrid mismatch arising between two other foreign countries. Some co-ordination and order is required so that the double non-taxation is countered appropriately. The OECD hybrid mismatch report outlines three tracing and priority rules to determine the order and extent to which deductions should be denied for imported hybrid mismatches which should be applied in the following order. This ordering is not codified in the legislation, although subsection (5) states that the amount of deduction denied under unstructured hybrid mismatches should be determined consistently with the approach used in chapter 8 of the OECD hybrid mismatch report.

### ***Structured imported mismatches***

The structured imported mismatch rule applies first to deny deductions to the extent there is a payment made under a structured arrangement that results in an overseas hybrid mismatch under subsection (3). This rule applies a tracing approach to determine the extent to which an imported mismatch payment made under a structured arrangement has funded a hybrid payment under the same arrangement.

### Example 27: Structured imported mismatch rule

In the example illustrated in the figure below, A Co (a company resident in Country A) is the parent company of the ABCDE Group. A Co provides financing to B Co (a wholly-owned subsidiary of A Co resident in Country B) under a hybrid financial instrument. Interest payments on the hybrid financial instrument are deductible under Country B law but not included in ordinary income under Country A law. B Co on-lends the money provided under the hybrid financial instrument to C Co and D Co (companies that are resident in Country C and Country D respectively). C Co on-lends money to E Co (a wholly-owned subsidiary of C Co resident in New Zealand).



The loans are all part of the same intra-group financing arrangement. The figure illustrates the group financing structure and the total gross amounts of interest payments made in each accounting period under this structure. E Co is the only group entity resident in a country that has implemented the OECD hybrid and branch recommendations.

#### Question 1

Whether the interest payments made by E Co to C Co are subject to adjustment under the imported mismatch rule in section FH 11 and, if so, the amount of the adjustment required under that rule.

#### Answer 1

E Co's imported mismatch payment to C Co and B Co's payment under the hybrid financial instrument to A Co are payments made under the same structured imported mismatch arrangement. New Zealand should, therefore, deny the full amount of the interest deduction (40) under the structured imported mismatch rule under section FH 11.

New Zealand will still impose non-resident withholding tax at the applicable rate on the interest paid by E Co to C Co.

#### Question 2

Whether the answer changes if Country C is a country that has implemented the OECD recommendations

#### Answer 2

E Co is no longer making a payment to a person in a foreign country that does not have hybrid mismatch legislation (as C Co is in Country C which has implemented the OECD recommendations), which means that section FH 11 will not apply. This is because the imported mismatch should instead be countered by C Co in Country C.

*Question 3*

Whether the answer changes if Country B is a country that has implemented the OECD recommendations.

*Answer 3*

If B Co is resident in a country that has implemented the OECD recommendations it should apply its hybrids rules so the payment from B Co to A Co is non-deductible. If this happens, there will be no hybrid mismatch for New Zealand to counteract.

*Direct imported mismatches*

To the extent the overseas hybrid mismatch has not been neutralised by one or more countries applying the structured imported mismatch rule, there is an unstructured imported mismatch, and subsection (4) applies. Subsections (4) and (5) provide that the amount denied should be determined consistent with the approach in chapter 8 of the hybrid mismatch report. Chapter 8 provides for a two rules to allocate unstructured imported hybrid mismatch payments. The first rule is the direct imported mismatch rule. This rule considers whether the foreign deduction from the overseas hybrid mismatch can be directly offset against an imported mismatch payment that is made by a member of the same control group.

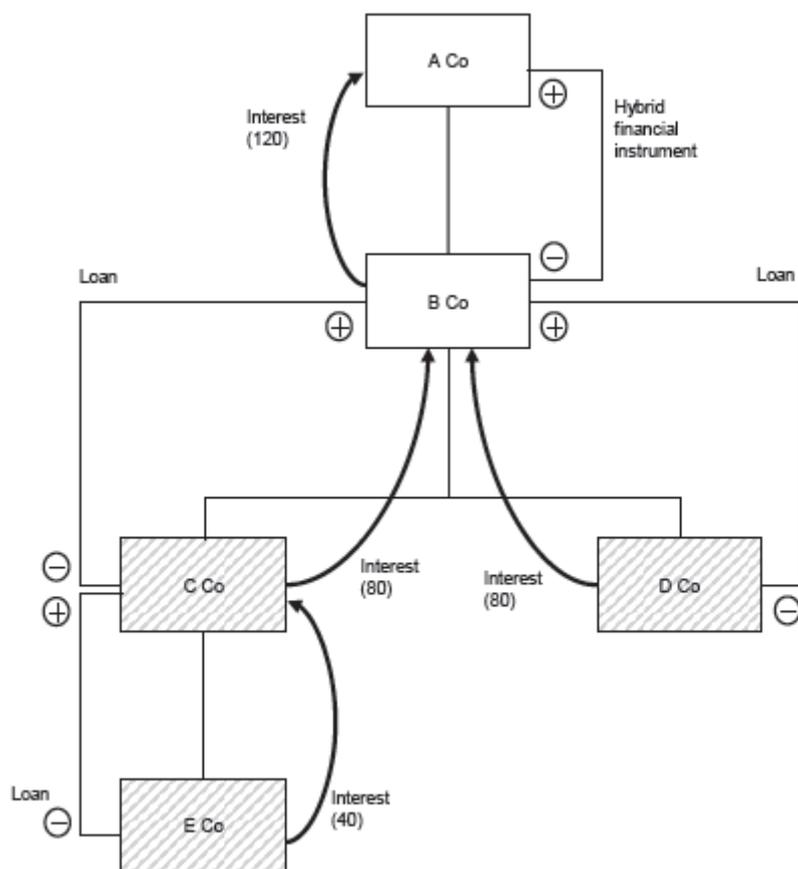
The rule applies an apportionment approach to help determine the extent to which a country should counter the overseas hybrid mismatch where more than one country has a direct imported mismatch. The intent of the apportionment approach is to prevent more than one country counteracting the same overseas hybrid mismatch such that there would be double taxation.

**Example 28: Structured imported mismatch rule and direct imported mismatch rule**

The facts are the same as above, except that B Co already has an existing funding arrangement in place with D Co that is unconnected with the group financing structure and that C Co, D Co and E Co (the shaded entities) are all resident in countries that have implemented the OECD hybrid and branch recommendations.

Assume in this example that D Co is resident in New Zealand.

The figure below illustrates the total gross interest payments made in each accounting period under the group's financing structure.



### Questions

Whether the interest payments made by C Co and E Co would be expected to be adjusted under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Whether the interest payments made by D Co are subject to adjustment under the imported mismatch rule in section FH 11 and, if so, the amount of the adjustment required under the rule.

### Answers

The structured imported rule should apply in Country C to deny the full amount of C Co's interest deduction (80).

The interest payment by E Co is made to a payee that is subject to the hybrid mismatch rules. The payment should therefore not be an imported mismatch payment.

The interest payment made by D Co should not be treated as made under a structured arrangement unless the D Co loan and the other group financing arrangements were entered into as part of the same overall scheme, plan or understanding (in which case a structured arrangement would arise). New Zealand should, however, apply the direct imported mismatch rule to deny half of the interest payment paid by D Co to B Co (40) under subsections FH 11(4) and (5).

### Indirect imported mismatches

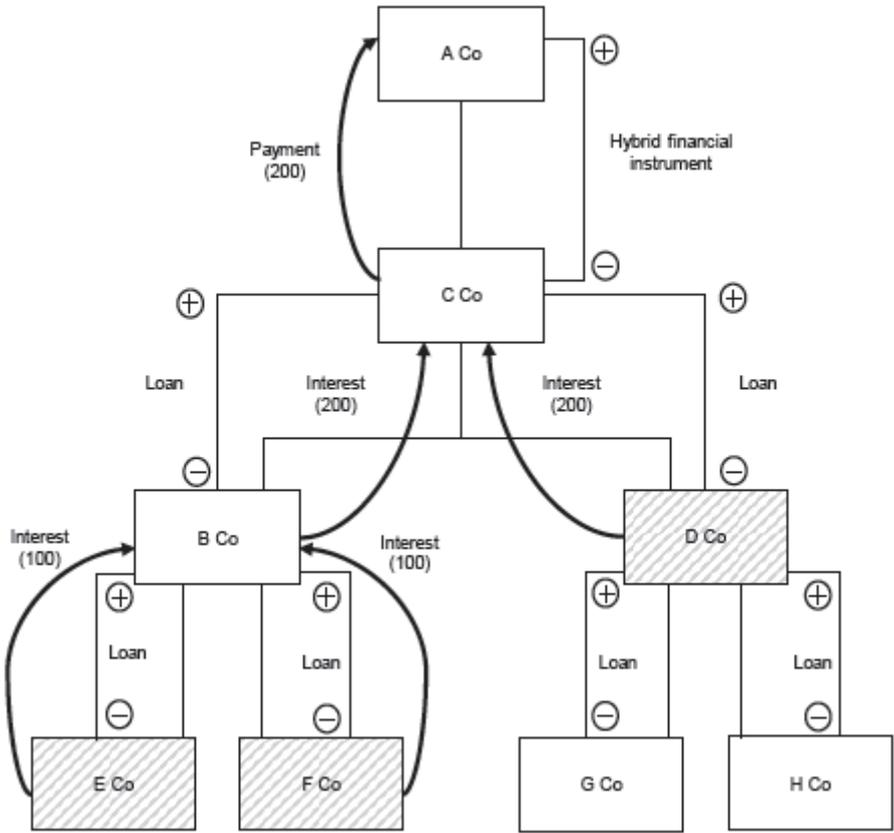
If the overseas hybrid mismatch has not been fully neutralised by one or more countries applying the structured imported mismatch rule and direct imported mismatch rule, the second unstructured rule is the indirect imported mismatch rule. This rule applies a tracing methodology to determine the extent to which the hybrid deduction from an overseas hybrid

mismatch has been indirectly funded by imported mismatch payments from other group members.

Like the direct imported mismatch rule, the indirect imported mismatch rule applies an apportionment approach to help determine the extent to which countries should counter the overseas hybrid mismatch which are direct imported mismatches for other countries. The intent of this approach is again to help prevent more than one country counteracting the same overseas hybrid mismatch such that it would result in double taxation.

**Example 29: Direct and indirect imported mismatch rule**

The figure below sets out the financing arrangements for companies that are members of the same group. In this case A Co has lent money to C Co. C Co has lent money to B Co and D Co and B Co and D Co have lent money to their subsidiaries. Each company is tax resident in different countries.



As illustrated in the diagram, the loan between A Co and C Co is a hybrid financial instrument. The hybrid financial instrument is not, however, entered into as part of a structured arrangement. The hybrid deduction arising under the hybrid instrument is 200. E Co and F Co each make a deductible intra-group interest payment to B Co of 100 and D Co makes a deductible intra-group interest payment to C Co of 200. D Co, E Co and F Co are the only entities in the group that are resident in a country that has implemented the OECD hybrid and branch recommendations.

Assume that E Co is resident in New Zealand.

*Question 1*

Whether the interest payments made by F Co and D Co would be expected to be adjusted under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Whether the interest payments made by E Co are subject to adjustment under the imported mismatch rule in section FH 11 and, if so, the amount of the adjustment required under the rule.

*Answer 1*

The direct imported mismatch rule should apply in Country D to deny D Co a deduction for all of the interest paid to C Co (200). This fully counteracts the hybrid mismatch between C Co and A Co. Therefore, E Co and F Co do not need to apply the indirect imported mismatch rule (that is, there is no counteraction required in New Zealand).

*Question 2*

Whether the above changes if the hybrid deduction arising under the hybrid financial instrument is 300 instead of 200.

*Answer 2*

The direct imported mismatch rule should still apply in Country D to deny D Co a deduction for all of the interest paid to C Co (200). This leaves 100 of the hybrid mismatch between C Co and A Co to counteract by E Co and F Co.

E Co and F Co apply an apportionment methodology to each deny half of their interest deduction (50). This leaves the other half of their interest deduction (50) as deductible.

## **SURPLUS ASSESSABLE INCOME**

---

### ***Section FH 12***

#### **Background**

Section FH 12 introduces the key OECD hybrids concept of ‘dual inclusion income’ which is referred to as ‘surplus assessable income’ in the Act. It is important as deductible/not includible (D/NI) payments and double deduction (DD) payments do not result in double non-taxation if they are deducted against dual inclusion income.

For instance, consider a deductible hybrid payment under section FH 8 where a New Zealand company is the sole investor in a hybrid entity in a foreign country. The hybrid entity makes payments that result in deductible expenditure in both New Zealand and the foreign country which results in denied deductions and a mismatch amount under subsections FH 8(2) and (3). However, the hybrid entity derives significant income that is taxable in both New Zealand (to the owner of the entity) and the foreign country. This means that there is net taxable profits in both countries, and there is no potential for the double deductions to be utilised against income that is only subject to tax in one country, so there is no tax mischief.

The purpose of section FH 12 is to reverse the denial of deductions (or inclusion of income, in the case of section FH 6) that arises under sections FH 5, FH 6 and FH 8 to FH 10 where there is surplus assessable income.

#### **Summary of legislative response**

Section FH 12 allows a deduction for hybrid mismatch amounts to the extent that the person paying or deriving the amounts has income which is taxable in New Zealand and can be expected to also be taxed in the other country giving rise to the hybrid mismatch. This income can arise in a different income year from the year the hybrid mismatch amount is disallowed.

Section FH 12 applies separately to each mismatch situation to which a person is party, but it applies to all mismatch amounts with respect to that situation. Both mismatch amount and mismatch situation are discussed separately above in the definitions part of this special report.

Section FH 12 defines surplus assessable income through a formula. Generally, it is surplus assessable income from earlier years which has not been offset by deductions for mismatch amounts, plus assessable income arising during the year from the structure which can be expected to be taxed in the other country also. There are adjustments for other items as well, including exempt dividends which can be included as surplus assessable income in some cases.

The carry forward of surplus assessable income and hybrid mismatch amounts is subject to the usual forty nine percent ownership continuity test that applies to tax losses.

#### **Application date**

Section FH 12 applies to income years beginning on or after 1 July 2018.

## **Detailed analysis**

### ***The importance of surplus assessable income***

Deductible/not includible (D/NI) payments result in double non-taxation where the deduction is used against income which is taxed only in the payer country. In that case the effect of the D/NI payment is to reduce payer country tax without increasing payee country tax. To the extent that the entity or branch earns income which is taxable in both countries (surplus assessable income), the D/NI payment will still reduce payer country tax, but it will increase payee country tax. That is because the payee country income calculation will not give a deduction for the D/NI payment. So, any tax reduction as a result of that payment in the payer country will simply reduce the amount of payer country tax for which a credit can be claimed in the payee country, and there is no tax mischief.

The same result holds for double deduction (DD) payments. If a DD payment by a hybrid payer is used against non-surplus assessable income, that can result in double non-taxation. However, if the hybrid is profitable in both the hybrid and owner countries, all of the double deduction expenditure (DD) will, broadly speaking, be deducted against surplus assessable income, and there is no tax mischief.

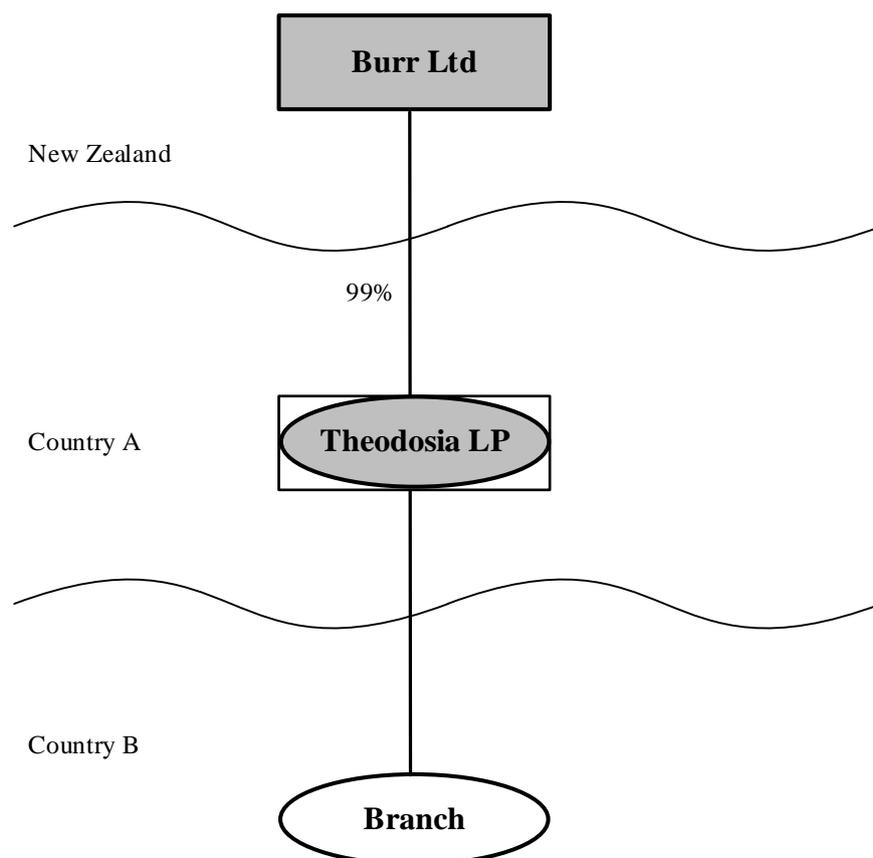
The purpose of section FH 12 is to reverse the denial of deductions (or inclusion of income, in the case of section FH 6) that arises under sections FH 5, FH 6 and FH 8 to FH 10 where there is surplus assessable income so that taxpayers are not inappropriately affected by the denied deductions (or inclusion of income) under the hybrid mismatch rules.

Unlike the OECD's dual inclusion income, surplus assessable income does not depend on the actual assessable amounts in each country. This is for reasons of pragmatism rather than principle. The approach is to focus on the New Zealand income as a starting point. For instance, if a \$100 amount of assessable income derived through a mismatch situation in New Zealand corresponds to a \$50 amount of taxable income offshore (because of a foreign exchange fluctuation, or because the income is recorded in a different way to New Zealand), the entire \$100 can be applied to the surplus assessable income formula. However, where income which is taxable in New Zealand will not be taxable in the other country because of more fundamental factors, like the structure through which that income is earned (for example, it is earned in a foreign branch, and the other country has an active foreign branch exemption, or its earned through a reverse hybrid entity) the income is not treated as surplus assessable income.

### ***Section FH 12***

Section FH 12(1) applies when a person has a hybrid mismatch amount for a mismatch situation. A person can have more than one mismatch situation.

**Example 30: Two mismatch situations**



Burr Ltd, a New Zealand resident company, owns 99.9 percent of Theodosia LP, a limited partnership formed under the laws of, and operating in, Country A (the remaining 0.1 percent is held by another group company). Theodosia LP is a hybrid entity, because it is taxed as a company in Country A and a partnership in New Zealand. It has a branch in Country B. Income and expenditure of the branch is not taxed in Country A because of an exemption for active branch income. Burr Ltd also owns one hundred percent of Mercer Ltd, a company incorporated and tax resident in Country A, which is in a tax consolidated group with Theodosia LP for Country A tax purposes.

Payments by Theodosia LP that relate to its Country A activities are deductible in New Zealand (to Burr Ltd) and Country A (to Theodosia LP).

Payments by Theodosia LP that relate to its Country B activities are not deductible in Country A but are deductible in New Zealand and Country B.

In this case, Burr Ltd is party to two mismatch situations, one with respect to its interest in Theodosia LP and one with respect to its interest in Theodosia LP's Country B branch. It will have a different mismatch amount for each one.

Subsection (2) requires a person's mismatch amounts (which can arise under different sections in subpart FH) from a mismatch situation to be set off against the person's surplus assessable income from the situation. This effectively reverses the impact of denied deductions (or inclusion of income) under the hybrid rules once the potential tax mischief is no longer present.

The formula for surplus assessable income in subsection (3) comprises a series of defined amounts; earlier plus assessable plus exempt less unrecognised less protected less deductions plus status. An explanation of these formula components is below:

- **Earlier:** Surplus assessable income not offset by mismatch amounts in previous years (subject to a reduction also for foreign tax credits in the other country, discussed below).
- **Assessable:** Assessable income that the person derives from the mismatch situation during the year.
- **Exempt:** If the person is a New Zealand resident hybrid entity owned by a non-resident, exempt consists of the New Zealand source dividends derived during the year if these are taxable to the foreign owner with no tax credit other than for withholding tax. This item recognises that the hybrid treatment of the New Zealand entity can cause a payment to be taxable in a foreign country with no deduction in New Zealand.
- **Unrecognised:** Assessable income from the mismatch situation which is not subject to tax in the foreign country because of the residence of another person (who is not another owner), or because of the source of the income. This item recognises that a taxpayer's mismatch situation may generate assessable income that is not taxable in the relevant other jurisdiction. This income should not count towards surplus assessable income.
- **Protected:** The amount of assessable income earned by the entity through its mismatch situation which is protected from New Zealand tax by a foreign tax credit. For a given year, this amount should be calculated under subpart LJ before a hybrid mismatch rule counteraction is made under subpart FH.
- **Deductions:** deductions for expenses incurred in earning assessable income which do not give rise to mismatch amounts.
- **Status:** the amount of expenditure on a payment by the person to a payee in New Zealand that is a mismatch amount and not deductible in a foreign country because of the tax status of the person and the payee. For instance, a payment made by a New Zealand hybrid entity that is denied a deduction under section FH 9 may have an amount of Status if that payment was made to a another New Zealand hybrid entity if the tax status of those entities results in the payment being disregarded in the relevant foreign country.

### Example 31: Surplus assessable income

Taking the facts of example 30, suppose the following amounts of income and expenditure during the year. The tax rate in all three countries is 25%.

*Burr Ltd, before applying subpart FH:*

	<u>New Zealand only</u>	<u>Country A only</u>	<u>Country B only</u>	<u>Total</u>
Assessable income	300	200	100	600
Expenses	150	210	40	400
New Zealand taxable income	150	(10)	60	200

For the Country A mismatch situation, Burr Ltd has a double deduction amount of \$210 and surplus assessable income of \$200, being:

- Assessable: \$300 (the amount of assessable income earned through Theodosia LP including through the Country B branch); less
- Unrecognised \$100 (the amount not recognised in Country A because it is from an active business in Country B).

(There is no Earlier amount as this is a one-year example. There is no Exempt amount on the facts. There is no Protected amount assuming no tax is paid in Country A. There is no Deductions or Status amounts as there are no deductions incurred in deriving assessable income from the mismatch situation other than hybrid deductions.)

Accordingly, of the \$210 deduction denied to Burr Ltd under section FH 8, \$200 is allowed as a deduction under section FH 12, and Burr Ltd has \$10 of denied deduction to carry forward to the next year.

For the Country B mismatch situation, Burr Ltd has a double deduction amount of \$40 and surplus assessable income of \$100, being the \$100 assessable income earned through the Country B branch. The other amounts in the calculation of surplus assessable income are zero.

So all of the \$40 deduction denied under section FH 8 for the Country B mismatch situation is allowed under section FH 12. For the Country B situation, Burr Ltd also has \$60 surplus assessable income which it can carry forward to the next year under subsection (6). This surplus assessable income cannot be used to claim a deduction for the \$10 of denied deduction for Theodosia LP's Country A double deductions because that deduction arises under a different mismatch situation.

### *Carry forward*

Mismatch amounts not offset against surplus assessable income in a year can be carried forward to the next tax year under subsection (6) provided that they meet the same forty nine percent continuity of ownership test as applies to tax losses (this is set out in subsection (8)).

Surplus assessable income that is not offset against mismatch amounts in a year can also be carried forward to the next tax year in the same way. However, before continuity is considered, subsection (7)(a) reduces the amount of surplus assessable income by the amount that is subject to the foreign tax credit regime of a foreign country equivalent to New Zealand's subpart LJ. This is to ensure that net New Zealand income from a mismatch situation cannot be offset against future mismatch amounts if double tax has been relieved by a foreign country through foreign tax credits in relation to that net New Zealand income.

### **Example 32: Disallowed carry forward of mismatch amount**

Further to examples 30 and 31, Theodosia LP (excluding its branch in Country B) has \$30 of double deductions and \$50 of surplus assessable income in year two. The \$10 mismatch amount for which a deduction was not allowed in year one can prima facie be deducted against the \$20 of surplus assessable income. However, the group that includes Burr Ltd, Theodosia LP and Mercer Pty Ltd is sold to a new owner at the beginning of year two. This sale will terminate the carry forward of the \$10 denied deduction with respect to the Country A mismatch situation. So that amount cannot be deducted in year two.

### *Stranded losses*

Subsection (9) provides for a situation where an amount for which a deduction is denied under section FH 8 (a double deduction amount) ceases to be a mismatch amount because the person treated as having the loss in the other country ceases to exist before the loss is used in the other country. This means the loss is no longer able to be used in that other country. This is referred to in the hybrid mismatch report as a "stranded loss".

The subsection applies where:

- a New Zealand person has a mismatch amount arising under section FH 8 available to be carried forward at the end of a year;
- the person who incurred the loss under the other country's rules (which may be the New Zealand person or a hybrid entity) ceases to exist; and

- under the law of the other country, in the year in which the mismatch arose or any later year, the person has not offset a loss against income which is not assessable in New Zealand.

If these requirements are met, the mismatch amount will be:

- in the case of a loss incurred by a foreign branch of a New Zealand person, treated as a tax loss component in the year the entity with the branch ceases to exist, in which case it can be offset against another group company's income in that year; or
- in the case of a loss incurred by a hybrid entity which ceases to exist, treated as an ordinary tax loss of the owner.

### *Grouping*

Subsection (10) is a grouping provision that allows a company to set off a mismatch amount from a mismatch situation against another company's surplus assessable income (from a different mismatch situation) if those companies are in the same group.

The subsection is available if:

- two companies are in the same wholly-owned group when the mismatch amount and surplus assessable income amount arise;
- the two companies have each applied FH 12 to offset their mismatch amounts and surplus assessable income mismatch amounts themselves, and the surplus assessable income amount are excess; and
- the offset could be made if the offset company and the group company were the same company. There does not need to be a nexus between the income and the expenditure for the two items to be grouped under this grouping rule.

A company cannot carry forward a mismatch amount or surplus assessable income amount that it has used for a grouping offset under subsection (10).

## DIVIDEND/SHARE ELECTION

---

### *Section FH 13*

#### **Background**

If a deduction is denied for an interest payment on a hybrid financial instrument under section FH 3 and the payment is also subject to NRWT (generally at 10% or 15%), there is an element of double taxation. Taxpayers can generally avoid this result by entering into non-hybrid arrangements. For instance, if a company raised funds by borrowing under a vanilla debt arrangement, the interest would be deductible (and not denied under section FH 3), and NRWT would be deducted at the appropriate rate (generally at 10% or 15%). Conversely, if a company raised funds by using equity, any dividends paid would not be deductible (such that section FH 3 would have no application), and NRWT would not apply where the dividends are either fully imputed, or where the taxpayer is entitled to NRWT at 0% under an applicable tax treaty.

The dividend/share election option in section FH 13 allows a New Zealand resident who makes a payment under a hybrid loan to treat the loan as a share for all circumstances in order to avoid any inconsistencies arising as a result of its being treated differently for different tax purposes. This means that any interest paid on the instrument will be treated as dividends for tax purposes. Distributions under the instrument may then be made without deducting NRWT if the payer attaches imputation credits to the deemed dividend, or where the taxpayer is entitled to NRWT at 0% under an applicable tax treaty.

#### **Summary of legislative response**

Section FH 13 allows a person who pays interest which is non-deductible by reason of section FH 3 to choose to treat the hybrid financial instrument on which the interest is paid as a share, and the payment as a dividend, for all tax purposes.

Taxpayers that wish to make this election should send their election notices to [hybridelections@ird.govt.nz](mailto:hybridelections@ird.govt.nz), where they will be monitored by Inland Revenue.

#### **Application date**

The election is available for income years beginning on or after 1 July 2018.

#### **Key features**

Section FH 13 allows a person who pays interest which is non-deductible by reason of section FH 3 to choose to treat the hybrid financial instrument on which the interest is paid as a share, and the payment as a dividend, for all tax purposes.

The election must be notified to the Commissioner before it takes effect, specifying the date on which it takes effect. On the effective date, the amount owing under the loan is treated as fully repaid by the person (which may trigger an NRWT obligation) and subscribed for an issue of shares having the same terms as the loan.

An election ceases to have effect if the interest payments are no longer subject to deduction denial under section FH 3. At that time the deemed shares are treated as cancelled for an amount equal to the amount payable under the loan, and that amount is treated as re-subscribed for the loan.

### **Detailed analysis**

Subsection (1) states who can make the election – a borrower who would be denied a deduction of interest under section FH 3 (the primary version of the hybrid financial instrument rule).

Subsection (2) states the broad result of the election, which is that while the person is eligible to make it, the financial arrangement giving rise to the payment is treated as a non-participating redeemable share for all purposes of the Act. This means that distributions on the financial arrangement will be treated as dividends for tax purposes. These dividends will be subject to the benchmark dividend rule in section OB 61.

Subsection (3) requires the election to be notified to the Commissioner specifying an elective date which must be on or after the date of the notice. Taxpayers that wish to make this election should send their election notices to [hybridelections@ird.govt.nz](mailto:hybridelections@ird.govt.nz), where they will be monitored by Inland Revenue. There is no prescribed form for the notice; however, it should include the taxpayer's name and IRD number, the financial arrangement to which the election applies, and the date on which the election is to be effective.

Subsections (4) and (5) outline in more detail the effect of an existing financial arrangement being subject to an election (the election can also be made for a financial arrangement yet to be entered into), and also the effect of it ceasing to be subject to the election.

On the effective date for the election the borrower is treated as paying all amounts owing under the financial arrangement. If this includes unpaid interest, this interest will give rise to an NRWT or AIL obligation as appropriate. The amount so repaid, less any NRWT, is then treated as subscribed for a non-participating redeemable share.

There is no provision for an election to be revoked. However, once the interest payments on the instrument are no longer subject to section FH 3 (for example, because the payee country implements recommendation 2 of the OECD hybrids report), the election becomes ineffective. The deemed shares are then treated as redeemed for the amount owing (which will include any accrued "dividend") and that amount, again less any NRWT, is treated as re-subscribed for the shares.

## OPAQUE ELECTION

---

### *Section FH 14*

#### **Background**

The hybrid rules impose a compliance burden on a person who is subject to New Zealand tax and has an interest in a foreign hybrid entity (that is, an entity which is fiscally opaque under the tax law of a foreign country, but transparent for New Zealand tax purposes. The person has to determine whether there are any deductions claimed by the entity in the other country for payments which are deductible in New Zealand as well (that is, DD mismatch under section FH 9). If section FH 9 applies, the person will also have to determine the expenditure attributable to the foreign entity and treat it as ring-fenced expenditure, only able to be deducted against surplus assessable income.

Section FH 9 is part of hybrid rules that target double non-taxation due to different rules relating to the tax classification of entities. Double non-taxation can also be addressed by New Zealand classifying the relevant entity in the same way as the other country. Section FH 14 allows a New Zealand owner of a foreign hybrid entity to take this approach in limited circumstances.

#### **Summary of legislative response**

Section FH 14 allows a New Zealand resident who has a wholly owned foreign hybrid entity when the Bill is introduced to elect to treat it as a company for New Zealand tax purposes. It is intended to simplify compliance for people who set up foreign hybrid vehicles before the hybrid rules were introduced.

Taxpayers that wish to make this election should send their election notices to [hybridelections@ird.govt.nz](mailto:hybridelections@ird.govt.nz).

#### **Application date**

The election applies for income years beginning on or after 1 July 2018. It must be made before the due date for the return of income for the first year in which the hybrid mismatch rules apply to the person.

#### **Key features**

Section FH 14 applies to a New Zealand resident who has, or is a member of a wholly owned group that has, a wholly owned hybrid entity. By making the election such a person can treat the entity as a company for New Zealand tax purposes. This will mean the person does not have to apply many of the hybrid rules in relation to the entity, particularly section FH 9. Of course, it will also mean that the entity's income is separate from the owner's income, so that, for example, losses from the entity do not reduce the owner's taxable income.

## Detailed analysis

Subsection (1) outlines who can make the election – a New Zealand resident who owns, or is a member of a wholly-owned group that owns, all the ownership interests in a hybrid entity on the date the Bill was introduced (6 December 2017). This is because the election is intended to simplify compliance for people who set up foreign hybrid vehicles before the hybrid rules were introduced.

Subsection (2) states the broad result of the election, which is that the hybrid entity is treated as a company for all purposes of the Act.

Subsections (3) to (7) then outline the specifics regarding the election and how it operates.

The owner must notify the Commissioner of the election on or before the due date for the person's tax return for the first income year in which the hybrid rules apply to the person (subsection (3)). Taxpayers that wish to make this election should send their election notices to [hybridelections@ird.govt.nz](mailto:hybridelections@ird.govt.nz). There is no prescribed form for the notice; however, it should include the taxpayer's name and IRD number, specific the foreign hybrid entity to which the election applies, and the tax year on which the election is to be effective.

The election will be effective from the first income year in which the hybrid rules apply to an owner and later income years (subsection (4)). This election will determine the New Zealand tax treatment of the entity for the remainder of its existence, regardless of who owns it in the future, as the election is irrevocable (subsection (7)).

The effect of the election is that the owners of the entity are treated as selling, on the first day of the income year, the hybrid entity's undertaking to a new company in return for the shares in the company (paragraph (5)(a)). The sale will in most cases trigger some taxable gain or loss, after which point the hybrid entity's undertaking will no longer directly be in the New Zealand tax base (that is, flow through treatment will not apply to the foreign hybrid entity's income and expenses immediately after the deemed sale has taken place). The CFC regime will apply in the usual way to the foreign hybrid entity following the election with distributions from the hybrid entity treated as dividends unless they qualify to be treated as a return of capital or capital gain distribution.

The available subscribed capital of the deemed new company will equal the net value of the undertaking it is deemed to acquire (subsection (6)).

### **Example 33: Opaque election**

NZ Co has had a wholly-owned a foreign hybrid entity in Country F since 1 April 2010. The foreign hybrid entity incurs tax losses each year in New Zealand which would effectively be ring-fenced under section FH 9. NZ Co understands that it will no longer benefit from potential double deductions from the foreign hybrid entity and wishes to reduce the compliance costs of the hybrid rules by making the opaque election in section FH 14. NZ Co has a standard balance date of 31 March.

#### *Question 1*

When does NZ Co need to make the election in election FH 14 by?

#### *Answer 1*

NZ Co must file the election before the due date for its 2019–20 tax return. If NZ Co has an extension of time for filing its tax return, this will be by 31 March 2021.

*Question 2*

What will the effect of the election be?

*Answer 2*

NZ Co will be deemed to sell the undertaking (or business) of the foreign hybrid entity to a new company in exchange for the shares in the company on 1 April 2019. If there is any taxable gain or loss from the sale, this will flow through to NZ Co. From that point onwards, foreign hybrid entity will be treated as a company for all purposes of the Act. NZ Co will file controlled foreign company disclosures for the foreign hybrid entity and treat equity distributions from the foreign hybrid entity prima facie as dividends.

*Question 3*

NZ Co sells the foreign hybrid entity on 1 April 2020 to Kiwi Co. Kiwi Co would prefer to treat the foreign hybrid entity as transparent for New Zealand tax purposes. How does NZ Co's section FH 14 election impact this preference of the new owner?

*Answer 3*

NZ Co's election is irrevocable and so Kiwi Co must continue to treat the foreign hybrid entity as a company for all purposes of the Act.

## FIF RULE CHANGES RELATING TO HYBRID RULES

---

*Sections EX 44(2), EX 46(6)(e), EX 46(10)(db), EX 47B, EX 52(14C) and EX 53(16C)*

### Summary of legislative response

The Act contains some amendments to the foreign investment fund (FIF) regime designed to ensure that a person holding a FIF interest must use the comparative value (CV) method to calculate FIF income from the interest if a distribution on the interest might otherwise be subject to counteraction under the hybrid rules. The amendments also turn off the ability for a share supplier of a FIF interest under a returning share transfer to use the fair dividend rate (FDR) method in relation to an arrangement within the scope of the hybrid rules.

### Application date

The changes apply for income years beginning on or after 1 July 2018.

### Key features

The key features of the FIF rule changes relating to the hybrid rules is that they require a person to use the CV method in relation to a FIF interest if:

- the FIF is entitled to a deduction or equivalent tax relief in relation to the distribution (subject to certain additional requirements); and
- the person holds the shares as a share user under a returning share transfer which is within the scope of the hybrid rules.

They also turn off the ability of a share supplier in a returning share transfer to use the FDR method in relation to FIF interests which are within the scope of the hybrid rules.

### Background

#### *Scenario 1*

A straightforward situation where the hybrid rules could apply to a New Zealand resident holding a FIF interest is where the arrangement is within the scope of the hybrid rules and the FIF is entitled to a deduction or equivalent tax relief for a distribution in its country. If the person is applying the FDR method:

- technically, the dividend is exempt income (section CW 9(1)); and
- the distribution may be greater than the amount recognized under the FDR method.

This may make it difficult to determine for the FIF to determine whether and to what extent the hybrid rules should apply in its country to the deductible dividend.

## ***Scenario 2***

A more complex scenario arises in relation to a FIF interest held by a New Zealand resident share user pursuant to a returning share transfer. The hybrid rules apply to hybrid transfers giving rise to a deductible/non-includible (D/Ni) result. One way this can occur is if a New Zealand person lends money to a foreign related party by way of a returning share transfer which is a share repo arrangement. In a share repo arrangement, the loan takes the form of an initial sale of shares by the borrower to the lender, followed by a sale back of equivalent shares. The lender may make a financing return by:

- receiving and retaining the dividend on the shares;
- receiving a greater amount for the sale back of the shares than it paid to acquire them.

In some countries, the cash borrower in a share repo arrangement is treated for tax purposes as continuing to own the shares, which it has provided as security for a loan. In this case, the tax law applying to the borrower will usually treat any dividend paid on the shares and retained by the lender as if it were both income to the borrower from the share and a deductible payment by the borrower to the lender. If the lender is a New Zealand person and exempt from tax on the dividend, this payment is deductible (to the borrower (share supplier)) and non-includible (to the lender/share user).

Application of the FDR regime, which taxes a deemed 5% return, complicates the picture, and would make it difficult to know whether or how to apply the hybrid rules to such a dividend payment. In order to avoid these complications, the legislative changes provide that the New Zealand lender (the share user) in such situations has to use the CV method to determine its income from the share. This ensures that the dividend is taxable to the lender, and the hybrid rules do not need to apply. It is analogous to the taxation of a deductible foreign equity distribution.

## ***Scenario 3***

A third scenario arises when a New Zealand resident supplies FIF interests under a returning share transfer which is a share loan. Under current law the person can continue to apply the FDR method as if they still held the shares. If the person is a share lender and receives a substitute payment which is deductible to the payer, this can give rise to a hybrid mismatch. In order to prevent this possibility, the legislative changes prevent such a person from applying the FDR method if the counterparty is related to the person, or the returning share transfer is a structured arrangement.

## **Detailed analysis**

### ***Scenario 1***

New paragraph EX 46(10)(db) deals with scenario 1 in the background above. It provides that in such a case the share is a non-ordinary share, which means income from it must be determined using the comparative value (CV) method. This method includes dividends in the calculation of the income, so there can be no hybrid mismatch arising from the payment.

New paragraph (db) only applies if:

- the arrangement is within the scope of the hybrid rules, because the parties are related or it is a structured arrangement;
- the non-resident is not a foreign PIE equivalent. In many countries, widely-held investment funds are entitled to a deduction or equivalent tax relief for distributions, designed to ensure that their investors, rather than the fund, are subject to tax on underlying income from the fund's investments. One example is an Australian unit trust (AUT), where income to which unit holders are presently entitled is taxed to them rather than the trust. This change is not intended to remove the ability for a New Zealand taxpayer to use the FDR method in relation to an AUT undertaking portfolio investment.

### *Scenario 2*

New section EX 47B deals with scenario 2 in the background above. In such circumstances, the New Zealand share user is required to use the CV method to calculate their FIF income or loss from a FIF interest subject to a returning share transfer if:

- the share supplier is resident in another country;
- the share user is related to the share supplier, or the returning share transfer is or is part of a structured arrangement. "Related" and "structured arrangement" are defined terms in new section FH 15 (discussed above); and
- the share supplier is treated as the owner of the shares for the purposes of the tax rules where it is resident.

This is because the share supplier may be deducting the dividends paid on the shares as a financing cost in the foreign country, whereas the share user may be applying the fair dividend rate (FDR) method to tax the FIF interest. The difference between the income returned under the FDR method and the dividend paid results in a potential D/NI mismatch.

There are consequential changes to related provisions in the Act:

- Section EX 44(2) has been amended so that new section EX 47B has been added to the list of the provisions which limit a person's choice of FIF income calculation methods.
- Section EX 46(6)(d) has been amended so that a person who holds a FIF interest as a share user in a returning share transfer can use the comparative value method to calculate FIF income from that interest if section EX 47B applies to the person.
- The definition of a "returning share transfer" in section YA 1 has been amended so it does not require that the transfer shares are listed.

### *Scenario 3*

Subsections EX 52(14C) and EX 53(16C) have been amended to deal with Scenario 3 in the background above. These subsections previously allowed a person who held a FIF interest and calculated income from that interest under the FDR method (whether it be the annual or periodic method) to continue to apply that method even if the person has disposed of the shares under a returning share transfer.

In practice, this seemed to mean that replacement payments paid by the share user could be treated as exempt (as dividends would be), and the share supplier would continue to pay tax only on the “fair dividend”. In order to avoid the potential for a hybrid mismatch counteraction in such a case (where the share user is a non-resident in a country with hybrid rules), subsections EX 52(14C) and EX 53(16C) have been amended to deny the ability take this approach if the share user is related to the share supplier, or the returning share transfer is part of a structured arrangement (“related” and “structured arrangement” are defined terms in new section FH 15 discussed above). In such circumstances, the share supplier now has to apply the financial arrangement rules to the returning share transfer. The financial arrangement rules are comprehensive, and will ensure that replacement payments are taxable.

## **NRWT CHANGES CONSEQUENT ON HYBRID RULES**

---

### ***Section RF 2C***

#### **Background**

One purpose of the non-resident financial arrangement income (“NRFAI”) definition is to identify situations where there is a sufficient degree of deferral between deductions and payments under a financial arrangement between associated parties that NRWT should be imposed on an accrual basis, rather than the usual payments basis. Applying NRWT on an accrual basis ensures that in such cases, there is a better matching between deductions for the borrower and the imposition of NRWT on the lender.

However, the NRFAI definition looks at when expenditure is incurred, rather than when it is deductible. This means that where a deduction for expenditure is denied or deferred under the hybrid rules, that denial or deferral is not taken into account, for the purposes of the NRFAI definition, because it does not affect the time when the expenditure is incurred. This is not appropriate. For example, suppose interest expense is incurred in a year, but the deduction for the expense is deferred under section FH 5. In that case there can be no deferral between the allowing of a deduction and the payment of NRWT until the deduction is allowed by the hybrid rules.

#### **Summary of legislative response**

The formula for determining whether a financial arrangement gives rise to non-resident financial arrangement income (NRFAI) in section RF 2C has been amended. It is intended to ensure that expenditure for which a deduction is denied or deferred under the hybrid rules is not taken into account in determining whether a loan gives rise to non-resident financial arrangement income.

#### **Application date**

The amendment applies for income years beginning on or after 1 July 2018.

#### **Detailed analysis**

Subsection RF 2C(4) has been amended to reduce the amount of the denominator in the formula used to determine whether a loan gives rise to NRFAI.

The accumulated accruals in the denominator is now reduced by the amount of deductions which have been denied under the hybrid rules in subpart FH (referred to as “hybrid deductions”).

## **THIN CAPITALISATION CHANGES CONSEQUENT UPON HYBRID RULES**

---

*Section FE 6(2), FE 6(3)(a), FE 6(3)(aba), FE 7(3)(b), FE 15(1)(a), FE 21(3), and FE 23*

### **Background**

The thin capitalisation rules prevent a multinational group taking deductions for interest expense in New Zealand to the extent that it is excessively highly leveraged. Leverage is determined by comparing debt with assets less non-debt liabilities.

If a deduction is permanently denied for interest under the hybrid rules, it is not appropriate for that amount to be treated as interest under the thin capitalisation rules. Such treatment could result in that amount being subject (effectively) to an additional denial of deduction. It is also not appropriate for the debt giving rise to that interest to be treated as interest-bearing debt. It should be treated as either equity or a non-debt liability.

If a deduction is denied under the hybrid rules, there is a possibility that a deduction will subsequently be allowed, by reason of being offset against surplus assessable income under new section FH 12. Application of the thin capitalisation rules to such interest should depend on the position of the New Zealand borrower and its worldwide group at the time the interest is incurred. Accordingly, no amendment to the current thin capitalisation rules is required in respect of such interest.

Separate thin capitalisation rules apply to registered banks controlled by a single non-resident. Consequential changes have been made to these rules for the same reason as for the generic thin capitalisation rules.

### **Summary of legislative response**

Sections FE 6, FE 7, FE 15, FE 21, and FE 23 have been amended to ensure that interest for which deductions are permanently denied under the hybrid rules do not give rise to additional income under the thin capitalisation rules (including the bank thin capitalisation rules), and that the debt associated with such interest is not treated as debt under those rules.

### **Application date**

The amendment applies for income years beginning on or after 1 July 2018.

### **Detailed analysis**

#### ***General thin capitalisation rules***

Section FE 6 provides that an entity subject to the thin capitalisation regime has income equal to, broadly speaking, that portion of its interest deductions that is equal to the extent to which its New Zealand debt/assets percentage exceeds the greater of sixty percent and one hundred and ten percent of its worldwide debt/assets percentage for inbound investment (the respective

percentages are seventy five percent and one hundred and ten percent for outbound investment).

Section FE 6 has been amended so that the formula in subsection (2) does not include, in the amount of interest which can give rise to such income under the thin capitalisation rules, the amount of interest for which a deduction is permanently denied under the hybrid rules. This is achieved through the following amendments:

- The formula in subsection (2) has been amended so that the interest deductions are reduced by a new term “mismatch”;
- “Mismatch” is defined in new paragraph (3)(aba) as the total of the amounts denied as deductions under section FH 3, and as interest under sections FH 7 and FH 11. These three sections contain the hybrid rules where the denied deduction is not a mismatch amount that can be reversed to the extent there is surplus assessable income under section FH 12; and
- The definition of “total deduction” in paragraph (3)(a) has been amended so that it includes the interest deductions that would be allowed in the absence of the hybrid rules in subpart FH. This is to reflect the intent that interest deductions that are potentially only deferred (rather than permanently denied) under the hybrid rules should remain subject to the thin capitalisation rules.

Section FE 15 outlines how total group debt should be calculated under the thin capitalisation rules for a New Zealand group. Subsection (1) has been amended to exclude from the definition of total group debt the amount of financial arrangements that give rise to interest for which a deduction is permanently denied under the hybrid rules (that is, where the deduction is denied under section FH 3, FH 7 or FH 11).

### ***Bank thin capitalisation rules***

Section FE 7 has been amended so that a reporting bank’s interest expenditure does not include interest for which a deduction is denied under sections FH 3 (for character mismatches only), FH 7, or FH 11 (those being the hybrid rules that permanently deny deductions).

Section FE 21 has been amended such that interest expenditure denied under sections FH 3 (for character mismatches only), FH 7, or FH 11 gives rise to additional financial value for the purposes of calculating equity value for a banking group. Correspondingly, Section FE 23 has been amended such that a banking group’s funding debt does not include debt under which a deduction has been denied under sections FH 3 (for character mismatches only), FH 7, or FH 11.

## HYBRID MISMATCH RULE FOR NRWT

---

### *Sections BH 1(4), RF 11C*

New section RF 11C inserts a new hybrid mismatch rule allowing New Zealand to charge NRWT on payments under certain cross border hybrid financing instruments if New Zealand treats the payment as interest. This rule overrides our double tax agreements (DTAs).

### **Background**

The Government has identified a hybrid mismatch issue that arises in the following circumstances.

The New Zealand branch of a non-resident company borrows money from another non-resident in the same overseas country as the borrowing company. The borrowing is under a hybrid instrument which New Zealand treats as debt but the other country treats as shares.

Under our DTAs, New Zealand is able to charge NRWT on interest payments made by a non-resident's New Zealand branch to another non-resident. However, New Zealand is not able to charge NRWT on dividends paid by one non-resident company to another (regardless of whether the dividends are connected with a branch in New Zealand). This means that whether New Zealand can charge NRWT on payments under a hybrid financial instrument where the borrower is a New Zealand branch of a non-resident and the lender is a resident of the same country depends on whether the payments are classified as interest or dividends for DTA purposes.

If the payments are dividends for DTA purposes, and New Zealand was not able to impose NRWT on them, then the branch would be entitled to an interest deduction in New Zealand for the payments but the payments would not be subject to NRWT. This would be contrary to the intent of the relevant DTA provisions.

Australia already has a rule effectively providing that outgoing payments are not dividends for DTA purposes (and so are subject to Australian NRWT) if they are treated as interest under Australia's domestic law.<sup>5</sup>

### **Application date**

New section RF 11C applies retrospectively from 1 April 2008. Where taxpayers have already adopted the position that NRWT or AIL is not payable in respect of such cross border interest payments made prior to the introduction of the Bill (6 December 2017), a savings provision is available.

### **Detailed analysis**

The Act inserts a new section RF 11C. Section RF 11C(1) provides that the section applies to a payment of interest (as defined in section YA 1) by a company that is resident outside New Zealand under an applicable DTA to another person who is also resident outside New Zealand

---

<sup>5</sup> Section 3(2A) of Australia's International Tax Agreements Act 1953

under that DTA, if the payment has a New Zealand source under the Income Tax Act. Section RF 11C(2) then provides that the payment is treated as interest under the NRWT rules and the DTA, notwithstanding anything to the contrary in the DTA. The Act also amends section BH 1(4) to make it clear that section RF 11C overrides the applicable DTA.

The combined effect of the legislation is that New Zealand may withhold NRWT from a cross border payment that is New Zealand source interest under the Act, regardless of whether it is treated as a dividend under the applicable DTA.

**Example 34: Hybrid mismatch in DTA/NRWT context**

A foreign group in the business of bridge building consists of two consolidated foreign companies resident in Greenwich (a foreign country), Simon Co and Garfunkel Co. Simon Co has a New Zealand branch and Garfunkel Co issues a convertible note to Simon Co to assist with its troubled New Zealand operations. (Assume for the purposes of this example that New Zealand and Greenwich have a DTA in force that is consistent with the commentary above.)

Simon Co must make annual payments to Garfunkel Co under the note and these payments are treated as interest under New Zealand domestic law, but as dividends in Greenwich. RF 11C(2) will ensure that the payment is subject to NRWT, regardless of its treatment in Greenwich or under the DTA.