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Addressing Hybrid Mismatch Arrangements – a Government Discussion Document

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Government discussion document *Addressing hybrid mismatch arrangements* (Discussion Document).

2. This submission is divided into two sections:

   a) Section A comments on a limited number of more general issues raised in Part I of the Discussion Document; and

   b) Section B comments on various submission points referred to in Part II of the Discussion Document.

3. All statutory references in this submission are to the Income Tax Act 2007 (the Act).

Section A: General issues raised in Part I of the Discussion Document

4. The Law Society accepts many of the proposals described in both the OECD's Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (Final Report) and the Discussion Document.

5. However, as indicated below, the Law Society is concerned that a number of the proposals contained in the Discussion Document risk placing undue burden on New Zealand taxpayers in furtherance of the global benefit sought to be achieved by them. The Law Society considers that while the adoption of the recommendations in the Final Report is in many cases appropriate (and possibly inevitable), care should be taken to ensure that New Zealand taxpayers are not unduly or unfairly impacted by the proposals.

Quantification of cost to New Zealand tax base

6. While the Law Society appreciates the notion that the Base Erosion and Profit Shifting (BEPS) initiatives are primarily designed from a global tax collection perspective, rather than with the implications for individual countries in mind, the Law Society nevertheless questions whether appropriate consideration has been given to the potential cost implications to New Zealand resulting from the proposed measures.

7. The Law Society would be interested to understand whether any analysis has been undertaken to project, for example:

   a) the anticipated increase in the collection of New Zealand tax as a result of the implementation of the proposals;

   b) the increased cost to New Zealand businesses in complying with the proposed measures; and

   c) the cost to New Zealand from the potential reduction in inbound investment resulting the proposed measures.

8. While the result of any such analysis would be only one factor in the decision to implement the hybrid proposals and would need to be balanced against the competing policy considerations detailed in Chapter 3 of the Discussion Document, there would be real benefit in attempting to understand and quantify the potential implications for New Zealand businesses. Without such analysis it is difficult to appropriately weigh the competing costs and benefits of implementation.

<u>New Zealand tax revenue loss caused by the use of hybrids</u>

9. The Law Society notes the comments made at paragraph 3.17 of the Discussion Document regarding the quantification of the New Zealand tax revenue loss caused by the use of hybrids:

   > *"The New Zealand tax revenue loss caused by the use of hybrids is difficult to estimate because the full extent of hybrid mismatch arrangements involving New Zealand is unknown. However, the tax revenue at stake is significant in the cases that the Government is aware of, which shows a clear advantage to counteracting hybrid mismatch arrangements. <u>For example, the amount at issue under all funding arrangements comparable to the Alesco arrangement referred to in Chapter 2 was approximately $300 million (across multiple years).</u> In relation to hybrid entities, deductions claimed in New Zealand that are attributable to some prominent hybrid entity structures result in approximately $80 million less tax revenue for New Zealand per year."* [emphasis added]

10. The Law Society considers that this statement significantly overstates the potential cost to the New Zealand tax base from the use of hybrids.

11. Taking the *Alesco*-style optional convertible note arrangement referred to in the paragraph – the Discussion Document suggests that the cost to the New Zealand tax base of the deductions claimed by the various taxpayers under those optional convertible note instruments was (leaving to one side the successful application of the general anti-avoidance rules) the entire $300 million of deductions collectively claimed by those taxpayers. That significantly overstates the cost. Absent the convertible note arrangements, many of the relevant taxpayers are likely to have been funded into their New Zealand activities with interest bearing debt. It is also likely, given the nature of the "holder election" instruments entered into in those cases, that the interest on that debt funding would have been paid at a higher rate than that treated as having been incurred under the convertible notes. The

elimination of a deduction no inclusion (D/NI) outcome in these cases would, in all likelihood, have resulted in a cost to New Zealand.

New Zealand's tax sovereignty

12. The Law Society notes that in many respects the proposals contained in the Discussion Document compromise the implementation of rules and policies that New Zealand has previously determined to be the appropriate basis of taxation from a country standpoint, best serving its interests domestically and internationally.

13. This point can be demonstrated through the example contained at paragraphs 5.29 to 5.30 of the Discussion Document. Under that example, a New Zealand purchaser of assets pays a deferred purchase price giving rise to deductions for the purchaser under the financial arrangements rules. If no income is recognised in the vendor's home jurisdiction, the sale and purchase arrangement would give rise to a D/NI outcome, which in certain circumstances would result in the deduction being denied under the proposed linking rule.

14. New Zealand has determined that taxation on an accruals basis under the financial arrangements rules represents the most appropriate manner of taxing financial arrangements. That regime risks being seriously eroded through the application of the linking rule in the example given above.

15. The recommendations in relation to the deactivation of domestic transparency in Recommendation 5.2 of the Final Report provide a further and important example. The recommendation, if implemented, has the potential to upset basic principles of New Zealand taxation – in particular, the non-taxation of foreign-sourced income derived by non-residents. This could have a significant impact on New Zealand's desirability as a destination for investment and its financial and professional services industry. These basic principles should not be eroded without careful consideration of the potential cost to New Zealand.

16. The question is whether it is appropriate for New Zealand to compromise the operation of its rules and policies to effectively compensate for shortcomings in the global tax net, arising from the less comprehensive or poorly designed methods of taxation implemented in other tax jurisdictions.

17. That compromise may be difficult to avoid as a result of combating some hybrid mismatches, but care should be taken to limit the impact of the proposed rules on New Zealand's existing tax policy to the greatest extent possible.

Section B: Responses to submission points identified in Part II of the Discussion Document

Submission point 5A

Outline of proposal

18. As part of Recommendation 2 in the Final Report, the OECD recommends that countries amend their domestic tax rules to ensure that a dividend exemption is denied in respect of

deductible payments made under financial instruments. This recommendation has no limitation on its scope.

19. New Zealand already denies the foreign dividend exemption in respect of rights to a foreign equity distribution under section CW 9(2)(c). This section is proposed to be expanded to also deny the foreign dividend exemption in circumstances where a dividend is paid, and the payment of the dividend gives rise to a tax credit in the payer jurisdiction.

Comment and recommendation

20. The Law Society anticipates that this proposal will be difficult for many taxpayers to comply with. Because the proposed amendment to section CW 9(2)(c) would be of general application, it is likely that in many circumstances the recipient of the dividend will be unable to determine whether the company paying the dividend is entitled to a tax credit in its home jurisdiction.

21. The Law Society recommends that the proposed amendment to section CW 9(2)(c) be limited to apply only in circumstances where the recipient of the dividend has reason to believe that the company paying the dividend is entitled to a tax credit in its home jurisdiction in respect of that dividend payment. This (or similar) test could be supported by guidance from the IRD in relation to the circumstances in various jurisdictions which would be likely to result in the application of the proposed amendment to section CW 9(2)(c). There is no reason that the "reason to believe" (or similar) test could not also be applied to the current deductible dividend limitation of the foreign dividend exemption, in respect of which there must also be difficulties with compliance.

Submission point 5C

Outline of proposal

22. The Final Report confirms that the hybrid financial instrument rule should not generally apply to differences in timing between the recognition of payments under a financial instrument.

23. Accordingly, it is recommended that no D/NI outcome should arise if the tax administration can be satisfied that the payment under the instrument is expected to be included in income within a reasonable period following the deduction.

24. The Final Report states in paragraphs 55 - 60 that this concept should be triggered if:

a) the payment will be included by the payee in ordinary income in an accounting period that commences within 12 months of the end of the payer's accounting period; or

b) the tax administration is otherwise satisfied that the payee can be expected to include the payment in ordinary income "within a reasonable period of time".

25. The Discussion Document notes that an alternative approach has been advocated in the Australian Board of Taxation Report, under which an income recognition deferral of up to

three years would not attract operation of the hybrid rules.[1] Further, where a deduction is denied because of a deferral of more than three years before recognition, that deduction denial would be reversed upon the subsequent inclusion of the relevant income.

26. The Discussion Document seeks submissions on whether the Australian Board of Taxation approach in respect of timing mismatches under a hybrid financial instrument would be acceptable in New Zealand, or whether an alternative option (such as that proposed in the OECD's Final Report and implemented in the United Kingdom) would be preferable.

Comment and recommendation

27. The Law Society agrees with the comments made at paragraph 5.45 of the Discussion Document that an approach similar to that advocated by the Australian Board of Taxation, which operates based on the application of objective timeframes rather than a subjective "reasonableness" test, would be appropriate in respect of the New Zealand's self-assessment tax system.

28. The Law Society further considers a timing gap of three years to be reasonable in determining whether a timing mismatch has arisen which should be subject to the hybrid mismatch rules (before reversal on any subsequent inclusion).

29. The Law Society also submits that it would be appropriate to incorporate a de minimis threshold in respect of the quantum of the deduction before the rules could apply. For example, if after a three year period the deduction(s) claimed exceeds the recognition of income by more than, say, $50,000, the rules would apply. The introduction of such a de minimis threshold would ease taxpayer compliance costs for what is ultimately only a timing advantage.

30. The Law Society also supports the proposal to allow for a carry-forward of any deductions temporarily denied under this proposed rule. Because the only advantage obtained by a taxpayer under an arrangement subject to this rule is a timing advantage, it is appropriate to only counteract that timing advantage and not the deduction in its entirety.

<u>Submission points 5D and 6D</u>

Outline of proposal

31. The Discussion Document proposes to disregard controlled foreign company (CFC) taxation in respect of considering both:

a) whether there is inclusion for the payee for the purposes of assessing whether a D/NI outcome arises in respect of Recommendation 1 (submission point 5D); and

b) whether dual inclusion income arises for the purposes of preventing the application of the disregarded hybrid payments rule in Recommendation 3 (submission point 6D).

[1] http://taxboard.gov.au/files/2016/05/Implementation-of-the-OECD-hybrid-mismatch-rules.pdf

32. The reasons given at paragraph 5.47 of the Discussion Document for the proposal to disregard CFC taxation for the purposes of Recommendation 1 are that:

(i) it will sometimes be complex to establish the extent of CFC taxation;

(ii) there is no need to do so when applying the secondary response; and

(iii) taxpayers can use alternatives to hybrid instruments.

33. The reason given at paragraph 6.28 in relation to Recommendation 3 is that it will avoid drafting a large amount of very detailed and targeted legislation which is aimed at situations that are unlikely to arise, and that in all likelihood will not deal appropriately with the peculiarities of such situations when they do arise.

Comment and recommendation

34. The Law Society opposes the proposal to disregard CFC taxation in the above circumstances.

35. The hybrid proposals should consist of a set of fair and principled rules to limit instances of non-taxation, rather than to impose penal double taxation. This point is commented on at paragraph 36 of the Final Report, where the OECD states that in respect of inclusion under a CFC regime:

> *"The hybrid financial instrument rule is only intended to operate where the payment gives rise to a mismatch in tax outcomes and is <u>not intended to give rise to economic double taxation</u>."* [emphasis added]

36. This point is again reiterated at paragraph 49 of the Final Report, which considers the nature and extent of the adjustment required under the hybrid financial instrument rule:

> *"The adjustment should be no more than is necessary to neutralise the instrument's hybrid effect and should <u>result in an outcome that is proportionate and that does not lead to double taxation</u>."* [emphasis added]

37. The Law Society does not find the reasons given at paragraphs 5.47 and 6.28 of the Discussion Document convincing. Ignoring CFC inclusion does not lead to a proportionate outcome. Each of the hybrid proposals will involve a complex set of rules which will be difficult to apply for taxpayers and the IRD alike. The complexity rationale would work against the implementation of any of the proposals. Similarly, the ability in many circumstances for a taxpayer to use alternative non-hybrid financing instruments does not justify the imposition of economic double taxation. If encouraging taxpayers to use alternative instruments is a key element of the non-inclusion, then a more appropriate and far less complex approach would be simply to prohibit the use of hybrids. As it stands, the proposals seek to counteract hybrid tax mismatches. It should be designed to do that successfully and not more.

38. If there are potential difficulties in establishing the extent of CFC taxation under some CFC regimes, the appropriate response would be for the relevant taxpayer to be subject to the burden of establishing that CFC taxation to the IRD. This is the approach adopted in the

OECD's Final Report, as summarised at paragraph 5.27 of the Discussion Document, and is the one that the Law Society considers should be adopted in New Zealand.

Submission point 5E

Outline of proposal

39. The Discussion Document outlines at paragraph 5.50 three possible approaches to address situations where a New Zealand resident holds an attributing interest in a foreign investment fund (FIF) which is subject to New Zealand tax under one of the fair dividend rate (FDR), cost, or deemed rate of return (DRR) methods.

40. Under current law a taxpayer applying one of these methods would be exempt from tax on any distributions received from the FIF. That would as a technical matter give rise to a D/NI outcome so as to potentially necessitate (if deductible in the payer jurisdiction) the denial of the deduction in the FIF country, or the inclusion of income in New Zealand.

41. In general terms, the three proposals outlined in the Discussion Document are to:

a) deny the FDR, cost and DRR methods to FIF interests on which deductible distributions would be made (Option A);

b) treat a deductible distribution as income of the New Zealand taxpayer in addition to any income recognised under the FDR, cost or DRR methods (Option B); or

c) treat a deductible distribution as income of the New Zealand taxpayer, to the extent that income has not already been recognised under the FDR, cost or DRR methods (Option C).

Comment and recommendation

42. In the Law Society's view, the order of preference of the above options is as follows (with the most preferable first): Option C, Option A, Option B.

43. Option C is the only option that would:

(i) prevent a D/NI outcome from arising so as to satisfy the hybrid mismatch objectives;

(ii) ensure that taxpayers are not subject to double taxation; and

(iii) allow impacted taxpayers the flexibility to continue to use the FDR, cost and DRR methods in respect of such investments.

44. Option B is the least preferable solution because it could result in economic double taxation for impacted taxpayers. As described above, the Law Society considers that the hybrid proposals should consist of a set of fair and principled rules which seek to limit instances of non-taxation and result in a proportionate outcome, rather than to impose penal double taxation on a taxpayer.

Submission point 7A

Outline of proposal

45. The reverse hybrid rule contained in Recommendation 4 of the Final Report seeks to neutralise D/NI outcomes arising from a payment made to a reverse hybrid. The proposal consists solely of a primary rule under which the payer jurisdiction will deny the deduction to the extent of the mismatch. The application of this rule is limited in scope to situations where the investor, reverse hybrid and payer are all members of the same control group, or there is a structured arrangement.

46. The Discussion Document seeks submission on whether there are any issues relating to implementing Recommendation 4 in New Zealand.

Comment and recommendation

47. The Discussion Document does not directly comment on whether inclusion as CFC income would be sufficient to prevent the application of a D/NI outcome from arising. However, given the comments detailed above in relation to the Discussion Document's treatment of CFC income in respect of Recommendations 1 and 3, it would appear likely that such income would be disregarded.

48. This outcome would be contrary to the statements made at paragraph 150 of the Final Report, which recommends that provided the taxpayer can establish such inclusion to the satisfaction of the tax authority:

> *"A payment that has been fully attributed to the ultimate parent of the group under a CFC regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the reverse hybrid rule."*

49. Consistent with the recommendation of the Final Report, and with the comments made above in respect of Recommendations 1 and 3, the Law Society submits that CFC inclusion should be treated as relevant for the purposes of implementing Recommendation 4 in New Zealand.

Submission point 7B

Outline of proposal

50. Recommendation 5.1 involves amendments to New Zealand's offshore investment regimes (the CFC and FIF regimes) to ensure that payments made to "reverse hybrids" which are fiscally transparent in the establishment country are subject to owner-level taxation in New Zealand.

51. By way of example, the Discussion Document anticipates that one method for counteracting such arrangements would involve an amendment to the CFC rules to provide that the owners of a CFC would be attributed with any income of the CFC to the extent that the establishment jurisdiction allocates that income to the owner for income tax purposes, and

that income is not subject to tax in that establishment jurisdiction as a result of that allocation (Option A).

52. The Discussion Document suggests two other solutions which have been adopted elsewhere:

a) the United Kingdom has adopted a narrower rule which would only include an amount as income of a United Kingdom investor to the extent to which a D/NI outcome arises having regard to the application of the hybrid rules in other jurisdictions (Option B); and

b) Australia already contains rules which seek to counteract mismatches arising from the use of reverse hybrids established in other countries, whereby a list of foreign entities is maintained that are treated as partnerships under Australian law to the extent to which they are fiscally transparent in their establishment jurisdiction (Option C).

Comment and recommendation

53. The Law Society considers that Options B or C would be more appropriate for adoption in New Zealand.

54. Option A has the potential for overreach, in that it might act to attribute CFC income to New Zealand investors in circumstances where the hybrid rules have already operated in another jurisdiction to prevent a D/NI outcome. That would contribute to a no deduction / income outcome. That outcome should not be risked if there are feasible alternative options (such as Options B and C).

<u>Submission point 7D</u>

Outline of proposal

55. Recommendation 5.2 in the Final Report encourages countries to implement domestic rules to deactivate tax transparency rules that achieve hybrid mismatches. The recommendation targets a situation where:

a) an entity is tax transparent under the laws of the establishment jurisdiction;

b) the person derives foreign source income or income that is not otherwise subject to taxation in the establishment jurisdiction; and

c) all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.

56. The Discussion Document confirms that in a New Zealand context, this could involve the taxation of the foreign-sourced income of partnerships and foreign trusts established in New Zealand where the income is allocated to an offshore investor within the same control group as the reverse hybrid, and the offshore investor treats the reverse hybrid as fiscally opaque.

57. In the case of foreign trusts, this rule would also potentially apply to require taxation in New Zealand where the income is treated as trustee income in New Zealand and is not taxed in any other jurisdiction.

Comment and recommendation

58. These proposals would involve New Zealand taxation of non-residents' foreign-sourced income. This is a fundamental change to long-standing tax policy.

59. Subsection BD 1(5) currently provides for the exclusion of non-residents' foreign-sourced income from the calculation of a person's assessable income. This is an outcome of New Zealand's right to tax being limited by the core principles of residence and source. In a trust context, section HC 26 operates to exempt foreign sourced income derived by a resident trustee where no settlor of the trust is resident in New Zealand (other than a transitional resident).

60. The June 2016 *Government Inquiry into Foreign Trust Disclosure Rules* (the Shewan Report) recently confirmed that the foreign settlor/resident trustee exemption represented sound tax policy. Paragraph 4.18 of the Shewan Report comments:

> *"The Inquiry considers that the current tax treatment of foreign trusts is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy."*

61. The Law Society considers that New Zealand should only adopt rules that abandon traditional limitations to taxation on the basis of residence and source as a last resort, and then in the most limited manner possible.

62. At least in relation to the use of New Zealand foreign trusts, the Shewan Report was satisfied that the introduction/enhancement of the various information reporting requirements for foreign trusts was sufficient to maintain New Zealand's international reputation without abandoning core principles of taxation. Perhaps similar disclosure rules in relation to New Zealand partnerships and other transparent entities would be sufficient to do the same without New Zealand taxing non-residents' foreign sourced income.

<u>Submission point 9A</u>

Outline of proposal

63. Recommendation 7 deals with situations where one entity is resident in two different countries, and is entitled to a deduction in each of those countries for a single payment.

64. The proposal is for both countries to deny the deduction to the extent that it is offset against non-dual inclusion income.

Comment and recommendation

65. Paragraph 9.3 of the Discussion Document acknowledges that where both residence countries have hybrid rules, it is possible for the disallowance of deductions under this recommendation to give rise to a double taxation outcome. However, the Discussion Document suggests that because in most cases dual residence status is deliberate rather than accidental, this outcome should be able to be avoided by taxpayers.

66. The Law Society makes two comments in relation to this approach.

67. First, it is incorrect to assume that, in most cases, dual residence status can easily be avoided or might be deliberately pursued by taxpayers. In many practitioners' experience, it is perceived by taxpayers as a risk to be managed because of the potential to create unwanted tax outcomes ranging from taxation in non-treaty jurisdictions to the denial of benefits similar to New Zealand's imputation regime (denied to dual resident entities).

68. A business operated cross-border can easily necessitate commercial units being established offshore. The autonomy of those units may range in practice depending on a number of factors: consumer preference; market size; local laws and customs; etc. In most cases, commercial (non-tax considerations) will dictate the level of presence and organisational control exercised in another jurisdiction.

69. The interaction of domestic tax residency rules that contain alternative tests for residency is not always clear and the risk of unintended dual residence is very real. This risk is heightened the more factually dependent the various tests are. The head office, centre of management and director control tests in section YD 2 are not straight-forward to apply in many cases and involve a factual inquiry with overlapping considerations. Each can involve a balancing of positive and contrary considerations in arriving at a view on application. The Law Society has not performed a review of the corporate tax residency rules in other jurisdictions. However, it is not difficult to imagine a range of different tests being applied to determine corporate residence status. The boundaries of the various tests in different jurisdictions based on anything but incorporation (or equivalent) can be expected to involve many of the same difficulties encountered in the application of our own tests for corporate tax residency. This all heightens the risk of unintended dual residence.

70. It is also possible that taxing authorities could reach inconsistent views on the application of similar tests following their own factual review and balancing other considerations.

71. Secondly, the Law Society submits that, regardless of whether dual residence status may be able to be avoided by taxpayers, the potential double taxation outcome envisaged by this proposal should not be pursued.

72. This proposal is another example of the rules deliberately imposing a double income penalty rather than simply addressing the tax result of hybridity. That approach risks overreach in a regime that addresses the outcome of hybrids as opposed to directly controlling their use.

73. The Law Society considers that the introduction of primary and defensive rules to ensure that the deduction is disallowed in only one of the countries in which the taxpayer is resident to be preferable to rules that risk double taxation.

Submission point 9B

Outline of proposal

74. At paragraphs 9.6 to 9.8 of the Discussion Document it is stated that the OECD Final Report encourages the adoption of a domestic law rule which deems an entity to not be resident for tax purposes if they are resident in another country through the operation of a double taxation agreement (DTA).

Comment and recommendation

75. The Law Society queries how in practice this proposal would interact with the proposed amendments to Article 4(3) of the OECD Model Tax Convention (discussed at paragraph 4.33 of the Discussion Document) which would provide that the tiebreaker mechanism for residence in a DTA will be resolved by the competent authorities of each DTA partner rather than through an interpretive rule as to the place of effective management.

76. The Law Society recommends that consideration be given to either (or both):

a) publishing guidelines to ensure that taxpayers will be aware of the types of circumstances which would be likely to result in them being deemed to be resident in New Zealand for DTA purposes through this competent authority mechanism;

b) a streamlined competent authority process so that taxpayers can obtain clarity upfront and in a timely way as to their residence status for tax purposes.

77. If taxpayers would lose their New Zealand tax residence status as a result of a decision of the competent authorities, taxpayers should be informed of the circumstances which would lead to such a decision, and should not be left in doubt for any significant period awaiting such a decision.

Submission point 10

Outline of proposal

78. Recommendation 8 deals with imported mismatches which arise when:

a) a payment is made to a recipient in a country that does not have hybrid mismatch rules;

b) that particular payment does not give rise to a hybrid mismatch; but

c) the recipient of that payment enters into a hybrid mismatch arrangement with a third party in another jurisdiction.

79. The proposal is that where the imported mismatch rule applies (i.e. within a control group or as part of a structured arrangement) a deduction for the original payment would be denied even though it does not give rise to a hybrid mismatch itself.

Comment and recommendation

80. The Law Society submits that the imported mismatch rule is likely to give rise to significant compliance costs concerns for New Zealand taxpayers in circumstances where the mischief arises entirely outside New Zealand, and the likely revenue collection will be minimal.

81. Requiring New Zealand taxpayers to consider the tax treatment in two other jurisdictions before claiming a deduction is unduly onerous.

82. If the imported mismatch rule is to be introduced in New Zealand, the Law Society submits that as indicated at paragraph 10.11 of the Discussion Document, adequate de minimis and safe harbour thresholds be introduced. It would make sense for New Zealand to set these de minimis and safe harbour thresholds at the same or similar levels to those decided upon in Australia, to ensure consistency across the two jurisdictions for subsidiaries in multinational groups which operate in both New Zealand and Australia.

<u>Submission point 11A</u>

Outline of proposal

83. At paragraph 5.10 of the Discussion Document it is suggested that the imposition of withholding tax on a payment is not full taxation as ordinary income (with the resulting implication that a deductible payment which is subject to withholding tax in the payer jurisdiction will be treated as a D/NI outcome, with that payment being deemed to be non-deductible).

84. At paragraph 11.4 of the Discussion Document it is then suggested that where a deduction is denied under the hybrid rules, this would not affect the underlying withholding tax treatment on that payment.

Comment and recommendation

85. The combined effect of these two statements will result in an overreach of the hybrid proposals. If the deduction on the payment which produces the D/NI outcome is denied in its entirety, but is still subject to withholding tax under the NRWT rules, the operation of the hybrid rules will result in an asymmetrical partial inclusion/no deduction outcome.

86. This is entirely inconsistent with the tenor of the NRWT proposals contained in the recent May 2016 *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill*. One of those proposals was to broaden the NRWT rules to apply in circumstances where a borrower that is an associated person of the lender incurs deductible financial arrangement expenditure.

87. As described at paragraph 2.21 of the May 2015 *NRWT: related party and branch lending* issues paper, that proposal was one of a number of changes intended to ensure symmetry between the tax treatment under the financial arrangements rules (under which a deduction

to the payer was allowed) and the NRWT rules (which previously did not impose a withholding obligation on financial arrangements rules expenditure):

> *"The suggested changes in this issues paper are aimed at helping ensure a more appropriate amount of tax is paid by non-residents on their New Zealand sourced income, thus better aligning taxation with real economic activity and reducing current asymmetries."*

88. It appears inconsistent to advocate for the need for alignment between deductibility and the imposition of NRWT in support of the proposal to broaden the scope of the NRWT rules on one hand, but on the other to suggest that alignment is unnecessary where a deduction is denied to the payer under the hybrid proposals.

89. The Law Society submits that the principle of alignment between the NRWT rules and the financial arrangements rules should be respected under the hybrid proposals as well as the proposal to increase the scope of the NRWT rules. This could be achieved by either:

    a) only partially denying a deduction under the hybrid rules in respect of a deductible payment that is subject to NRWT, but does not produce income in the country of the recipient, reflecting that there is not a full D/NI outcome; or

    b) (more simply) relieving a payment from the imposition of NRWT where a deduction on that payment has been denied under the hybrid proposals.

<u>Submission point 11D</u>

Outline of proposal

90. At paragraphs 11.17 to 11.19 the Discussion Document considers the merit of legislating in broad principles which could be "fleshed out" by regulations of some kind.

Comment and recommendation

91. The Law Society submits that, to the greatest extent possible, the detail of the hybrid mismatch rules should be expressed in the Act rather than in regulations.

92. While regulations may provide a more flexible option which would allow for the rules to be more easily amended over time, there is a risk that:

    a) flexibility in amendment may compromise taxpayer certainty; and

    b) amendments would be made without full consultation.

<u>Submission point 11E</u>

Outline of proposal

93. The Discussion Document puts forward the view that because the impact of the hybrid mismatch proposals will in most cases be able to be established now by reference to the OECD's Final Report, there is no need to introduce any grandfathering provisions.

94. Instead, the new hybrid mismatch rules would apply to payments made after a taxpayer's first balance date following enactment. Taxpayers are considered to have enough time between the introduction of the relevant legislation and its enactment to restructure any arrangements which might be impacted by the proposal.

Comment and recommendation

95. The Law Society submits that taxpayers should be afforded a reasonable period of time to consider any hybrid mismatch legislation in its final form, and to implement any restructuring arrangements prior to the effective date.

96. Whether the proposed timeframe set out in the Discussion Document would in practice afford taxpayers such time will be likely to be determined by the period of time it takes from introduction to enactment, and the significance of any changes to the draft legislation produced at introduction.

Conclusion

97. This submission has been prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

Kathryn Beck
President