

# Tax Tips Alert

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## Addressing hybrid mismatch arrangements – Government discussion document

On 6 September, the Government released a [discussion document](#) outlining proposals to address hybrid mismatch arrangements. As expected, the Government intends to adopt the full range of OECD recommendations, with some minor amendments to fit with New Zealand's current domestic and international tax rules.

The proposed changes are complex. The discussion document discounts the possibility of only introducing specific and limited targeted rules. Instead, the Government's preference is to fully adopt the OECD recommendations. This is likely to result in some significant and highly complex legislative changes. The document calls for submissions on how these changes should be incorporated into New Zealand law, and states that final policy decisions will be made after the consultation phase.

Businesses that engage in cross-border transactions will need to come to grips with these intricate rules if they become law. This may take some time, and consideration will need to be given to existing transactions as well as any prospective transactions. The discussion document provides examples of arrangements that may be impacted by the proposed rules, including:

- debt instruments issued by a New Zealand taxpayer, but viewed as equity by the foreign holder, such as:
  - optional convertible notes or mandatory convertible notes
  - notes issued by New Zealand branches of banks giving rise to interest deductions in New Zealand and frankable dividends in Australia
- New Zealand taxpayers entering into collateralised loan arrangements or share lending transactions
- New Zealand unlimited liability companies, treated as transparent for United States tax purposes
- New Zealand branches of foreign companies, or foreign branches of New Zealand companies
- New Zealand partners of Australian limited partnerships
- New Zealand partnerships (general or limited) with foreign partners
- New Zealand taxpayers with foreign investments under the foreign investment fund (FIF) regime
- certain trust structures.

The focus of the proposals is on eliminating certain “hybrid mismatched arrangements” where payments under these arrangements utilise the differences in the tax treatment of an instrument or entity under the laws of two or more countries resulting in double non-taxation (or reduced overall taxation). Examples of how the double non-tax advantage arises include (i) obtaining a deduction in one jurisdiction but no income inclusion in the other, (ii) a deduction in each jurisdiction, or (iii) a deduction in one jurisdiction and, indirectly, no income inclusion in another jurisdiction up the chain.

The proposals include the implementation in New Zealand's domestic tax legislation of a series of “linking rules” contained in the OECD report which seek to adjust the tax treatment of a hybrid mismatched arrangement in one country by reference to the tax treatment in the counterparty country. The Government has stated that it is looking closely at the equivalent proposed tax changes in the United Kingdom (UK) and Australia. In our view, New Zealand should not aim to follow the timelines of Australia and the UK too closely, given both the UK and Australia have had these proposals in discussions for a period already. We understand delays are already likely for the Australian tax changes. For New Zealand, the proposed rules are expected to take effect for payments made after the first tax balance date following enactment. Given the complexity of the changes, we consider that a longer deferred start date post-enactment will be required in New Zealand (even though the New Zealand legislation is unlikely to be enacted until the first half of 2018).

In this issue of Tax Tips, we outline the key proposed changes.

## Hybrid financial instruments

The proposed changes to New Zealand legislation are targeted at payments made under cross-border transactions such as dividends and interest, timing mismatches, and asset transfers that take advantage of a difference in jurisdictional tax treatment of the financial instruments.

Key New Zealand legislative changes being considered include:

- denial of a deduction for the payer if the payment on a financial instrument is to a related party or part of a 'structured arrangement' and is not treated as ordinary income in the payee's country (the 'primary' rule). How (and when) to apply the 'secondary' rule is considered, where the payee country should include the payment in the payee's income if the payer country has not denied the deduction
- extending the denial of an exemption for a foreign dividend that gives rise to tax relief in the payer jurisdiction
- denial of imputation credits to reduce tax on a dividend to the recipient that is deductible to the payer.

To address timing mismatches between the tax rules in different jurisdictions, the document calls for comments regarding whether to follow the Australian Board of Taxation's suggested approach. This is to deny deductions where there is a deferral of recognition of the corresponding income for more than three years. Denied deductions will be available to be carried forward and claimed against dual inclusion income in future periods (subject to continuity requirements).

Various proposals are discussed in the context of specific situations, including the taxation of FIF interests, transfers/sales of assets that are categorised as hybrid transfers (e.g. share lending arrangements) and bank regulatory capital instruments.

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## Hybrid entities

The Government's recommendations relating to hybrid entities are intended to target mismatches that arise due to the different tax treatment of an entity between two countries, which is a result of differences in the jurisdictional tax rules. It continues with the "linking rules", and provides for a 'primary' rule, adoption of specific domestic law recommendations, and in certain instances, a 'secondary' rule if the counterparty country does not have hybrid rules.

### *Disregarded hybrid payments*

Disregarded hybrid payments arise when a deductible cross-border payment has been disregarded by the payee country due to that country's treatment of the payer as an entity (e.g. tax transparent or not). For example, a New Zealand payer that is an unlimited liability company wholly owned by a US parent. The entity is fiscally opaque in New Zealand but treated as a foreign branch by the US parent. When a payment is made to the US parent there is a deduction in New Zealand but no income inclusion in the US.

In this case, it is proposed that the payer country will deny the deduction ('primary' rule) or, if not, then the amount is included as income in the payee's country ('secondary' rule).

### *Reverse hybrids*

A reverse hybrid is an entity where some or all of its income in its establishment country is treated as derived by its investors (i.e. tax transparent) and, in its investor country, is treated as derived by the entity itself. In this instance, a payment received by the reverse hybrid entity may not be subject to tax by the establishment country or investors.

The proposed rules provide that the payer is denied the deduction for the payment where the payer, reverse hybrid and investors are part of the same control group, or party to a structured arrangement.

These changes could be relevant for New Zealand limited partnerships or New Zealand investors in Australian limited partnerships. Foreign branches and certain trusts may also be treated as reverse hybrids.

The document discusses specific recommendations about how to deal with the potential hybrid mismatches. In particular, whether domestic law changes are required for New Zealand's current CFC and FIF rules, restrictions on the tax flow through status of such reverse hybrid entities, and whether New Zealand's current requirements are in line with OECD recommendations for information and filing requirements for transparent entities.

## *Deductible hybrid payments*

These recommendations relate to payments that are deductible in two countries, either by the same entity or deductions claimed by related parties for the same payment. In such case, the 'primary' rule is that the owner country is denied the deduction, with a 'secondary' rule, that the payer is denied the deduction when the owner country does not have hybrid rules.

The proposed rules are particularly relevant to New Zealand residents with a foreign branch that is generating losses, depending on the tax treatment in the other country. It is intended that an immediate deduction will not be able to be claimed for a foreign branch loss except against income from the same country. The rules may also impact a New Zealand unlimited liability company wholly owned by a US parent (see above).

### *Dual resident payers*

There are recommendations relating to dual resident entities and a situation where a single payment is deductible in two countries by the same entity (by virtue of the entity's dual tax residence) unless the entity has corresponding dual inclusion income. The document proposes to introduce a New Zealand domestic rule that deems an entity not to be resident in New Zealand if that entity is resident of another country through the operation of a double tax agreement.

## Imported hybrid mismatches

The document also proposes a rule termed 'imported hybrid mismatches'. Under the proposals, a hybrid mismatch not directly involving New Zealand may result in a New Zealand taxpayer being denied tax deductions for non-hybrid payments it makes due to hybrid payments made by the related recipient (or indirect recipient) to a third country. This rule may apply to a New Zealand subsidiary of a multinational group.

This proposal poses real concerns over the complexity and required knowledge that would be needed by New Zealand subsidiaries of the global group structure.

## Concluding comments

The Government recognises the effectiveness of any proposed changes will depend on a global coordinated approach. The discussion document cites Australia, the UK and the Council of the European Union as leaders in this area and notes that adopting the recommendations in full has the advantage of consistency with the intended approach of Australia and the UK. However, the document does not comment on the US (who is unlikely to adopt the OECD recommendations) or Asian countries. Wider consideration (beyond Australia and the UK) should be given to the most common jurisdictions for capital funding into New Zealand and their approach to the recommendations.

While we understand the driver behind the proposed changes, it is important not to underestimate the technical and practical difficulties that a New Zealand entity may face under the proposals (and particularly understanding the legislative regime implemented which will be complex). Further guidance on the implementation of the changes from a practical perspective should be considered, although the discussion document does include

some comments as to how these anti-hybrid rules will interact with existing tax regimes such as thin capitalisation, transfer pricing, and withholding taxes. For example, the proposals do not seem to consider the practical difficulties a New Zealand entity that is part of a large multinational group can have in accessing information about the wider group and its transactions, or the complexity of applying certain aspects of the proposed rules, such as calculation of 'dual inclusion income'. It is critical that consideration is given to practical issues in the development of any resulting legislative change.

New Zealand taxpayers potentially affected by these changes should consider what the practical impact may be for their businesses. The discussion document seeks submissions on these points.

No detailed indication of timing is included in the document. It is noted that the suggested application date of the changes will be from the first financial year after enactment. We consider that it is paramount that any resulting change is subject to comprehensive consultation and that legislation is not rushed to ensure the complexity of the rules can be reduced as much as possible.



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