KPMG

TaxMail

8 September 2016

Regular commentary from our experts on topical tax issues

Issue 2

Am I my brother's keeper? Part II – looking after myself too

New Zealand's implementation of the OECD hybrid mismatch recommendations is expected

The proposals, however, go further than a simple implementation

They have a potentially wide and detrimental impact

Snapshot

A Government discussion document, Addressing hybrid mismatch arrangements, outlines the case for implementing the OECD's BEPS Action 2 recommendations and raises matters of technical detail to "New Zealand-ise" them.

A comprehensive application of the OECD hybrid rules is suggested. These rules will deny deductions or remove tax exemptions relating to hybrids to prevent "double non-taxation". This has the potential to protect other countries at the cost of investment in New Zealand. This is justified by the draft framework for taxing inbound investment – a common approach will produce benefits which outweigh this risk.

The matters of detail that need to be considered are wide ranging. There is the potential for the proposals to apply in unexpected ways. Despite the reach of the proposals, and important questions of policy and principle, there is a very short timeframe for submissions, which are due by 17 October 2016.

On current timelines, the proposals are likely to be included in a February/March 2017 Tax Bill with enactment a year later. Their effective date is potentially 1 April 2018.

Contact us

John Cantin
Partner
T: +64 4 816 4518
E: jfcantin@kpmg.co.nz

Rachel Piper
Partner
T: +64 9 363 3525
E: rkpiper@kpmg.co.nz

Who's impacted and when?

Potentially, anyone with cross-border transactions will be affected by the proposals. The document needs to be considered and applied by all. However, those who:

- deduct interest or other amounts where the equivalent income is not immediately taxed or not taxed at all;
- apply the FDR method for some foreign share investments;
- derive as trustees foreign income which is not taxed anywhere;
- invest in foreign limited partnerships (or New Zealand limited partnerships);
- have foreign branches or CFCs;
- have issued instruments which qualify as regulatory capital; or
- receive dividends with foreign tax credits or certain imputation credits;

may find the proposals could affect their tax position.

The new rules will apply to existing arrangements either from a specific date or an income year. The Government considers that a long lead-time is not required. The draft legislation will provide detail of the rules which can be acted upon.

What are the proposals?

The OECD recommendations aim to prevent "double non-taxation" due to mismatches in the tax treatment of financial instruments or particular types of entities. Double non-taxation will typically arise because one country allows a deduction for an expense while another does not tax the receipt as income.

To prevent this, the OECD proposes a rule that the paying country should deny a deduction if the income country does not tax it. If the paying country allows a deduction, the income country should tax it. The end result should be that one country levies tax.

Equivalent outcomes can arise for entities and other hybrid mismatches. Similar rules are proposed for these.

Part 1 makes the case for why New Zealand should implement the OECD recommendations. It states that consistent global application of the recommendations will reduce detrimental tax planning for New Zealand.

Part 2 applies the OECD recommendations to New Zealand. This part is very technical. It summarises the 450+ page OECD report and raises possible implementation options for New Zealand. These are broad and wide ranging.

Generally, Part 2 makes sense only if you understand the effects of the arrangements described. We have avoided summarising the detailed proposals.

Our view

Pragmatism over principle?

The Government's approach is as expected, but is not fully convincing. This is because the OECD approach can be described as pragmatic rather than principled.

The principled approach is to globally align what is treated as debt and equity, what is treated as a company or not, and who is resident or not. This allows consistent treatment between countries. It reduces unintended opportunities for both double taxation and double non-taxation.

This approach is dismissed as "only theoretical". In other words, there is no realistic possibility of different Governments and Revenue Authorities agreeing. The suspicion is that the objective is to increase, rather than allocate, tax. This will lead to double taxation. This is accepted as New Zealand's withholding tax rights will remain.

Contact us

John Cantin
Partner
T: +64 4 816 4518
E: jfcantin@kpmg.co.nz

Rachel Piper
Partner
T: +64 9 363 3525
E: rkpiper@kpmg.co.nz

The discussion document seems to have been prepared in isolation. The May Tax Bill proposes changes to non-resident withholding tax. It will apply when a deduction for interest is allowed. The discussion document proposes the opposite. Withholding tax will still apply when a hybrid rule applies to deny or defer a deduction. Despite Officials' passionate advocacy for alignment, the principle seems to have been readily and easily abandoned.

Broad ranging effects

The discussion document does not simply apply the OECD recommendations. There is a fundamental re-think of the taxation effects of affected cross-border transactions. This means these are wide ranging, and potentially unintended, effects.

For example, investors are unlikely to consider the FDR rules as concessionary. Tax is payable even when the dividend is less than the 5% deemed taxable return. That the current dividend treatment is seen as problematic is, in our view, an indicator of the unprincipled approach being taken.

Collateral damage? The effects on investment and commercial arrangements

The Government expects the new rules will not actually raise much in the way of tax. Affected hybrid arrangements will be restructured to simpler and more direct arrangements. This may reduce investment in New Zealand.

The discussion document states that New Zealand could accept a deliberate decision by another country not to tax an item. In that case, a deduction would be justified. However, as it is not obvious that an exemption is deliberate, New Zealand should apply the recommendations on a blanket basis.

Given that most investment in New Zealand is from countries with sophisticated tax systems and Revenue Authorities this is difficult to accept. The hybrid instrument rule applies if the other country does not tax an amount when New Zealand allows a deduction. A rule to tax New Zealand deductible amounts is relatively straight-forward. It is hard to escape the conclusion that its absence is by design. The proposals protect foreign countries (despite themselves) at the potential cost of investment in New Zealand.

There is also a real concern that the hybrid proposals will affect commercial arrangements. It is difficult to discern any concern for the effect on commercial structures in the document.

The discussion document needs detailed consideration to identify unexpected and potentially unintended consequences, which justify modification to the proposals. We say "modifications" because, despite potentially good arguments to the contrary, the fact the proposals are in a Government discussion document means the policy has the Government's support. Unfortunately, the very short time for submissions increases the risk that bad policy will result.

The impact of the proposals and the need for change need to be assessed and plans readied. We are happy to assist.

For further information

John Cantin
Partner, Tax
Wellington
Phone: +64 4 816 4518
Email: jfcantin@kpmg.co.nz

Rachel Piper
Partner, Tax
Auckland
Phone: +64 9 363 3525
Email: rkpiper@kpmg.co.nz

kpmg.com/nz

twitter.com/KPMGNZ