Coversheet: BEPS - Hybrid mismatch arrangements

Advising agencies	*Inland Revenue, The Treasury*
Decision sought	*This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.*
Proposing Ministers	*Steven Joyce (Finance) and Hon Judith Collins (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The policy problem is that taxpayers can reduce their worldwide tax liability through hybrid mismatch arrangements, which in most cases are deliberately designed to take advantage of the different characterisations countries use for financial instruments and entities. Hybrid mismatch arrangements (which include branch mismatches) result in less group taxation when compared with straightforward arrangements that are seen consistently by the relevant countries.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
A tailored adoption of the OECD's BEPS Action 2 recommendations will comprehensively deal with the problem of hybrid mismatch arrangements while making modifications and variations to take into account what is appropriate for the New Zealand context. This tailored solution is sustainable and achieves gains to efficiency and fairness, while minimising compliance costs where possible. There will be a significant benefit in adopting a solution which is adopted by other countries and which will therefore be easier for multinational businesses to understand and comply with.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The Government will benefit in that new rules to counter hybrid mismatch arrangements are forecast to produce approximately $50 million per year on an ongoing basis. There are also efficiency and fairness benefits to this regulatory proposal which cannot be assigned to particular beneficiaries.

Where do the costs fall?
Taxpayers that use hybrid mismatch arrangements will face a medium level of compliance costs. These may be up-front, in the form of restructuring costs to transition to more straightforward (non-hybrid) arrangements, or they may be ongoing in the case of taxpayers that keep their hybrid mismatch arrangements in place and must apply new tax rules in order to comply with the law.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
There is some risk of taxpayer noncompliance with the proposed rules. However, the risk of taxpayers being inadvertently caught by the proposed rules has been minimised due to the design of the preferred regulatory option which seeks to exclude the most simple offshore structures (foreign branches). More generally, the impacts have been reduced through the proposals taking into account the New Zealand context and adjusting the OECD-recommended rules as needed.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Not every type of hybrid arrangement that would be countered by the proposals has been observed in New Zealand. However, Inland Revenue is aware of some historic and current hybrid arrangements, and there is a very high likelihood there are others that relate to New Zealand and will be affected by this regulatory proposal.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the BEPS – hybrid mismatch arrangements Regulatory Impact Assessment prepared by Inland Revenue and associated supporting material and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Impact Statement: BEPS - Hybrid mismatch arrangements

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final tax policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Evidence of the problem Our analysis has been limited somewhat by our inability to assess the exact size of the hybrid and branch mismatch arrangements problem in New Zealand. Inland Revenue is aware of some mismatch arrangements, but the full extent of the problem is unknown. This is because evidence of the problem primarily comes from Inland Revenue's investigations staff. Under current law these staff do not routinely examine offshore tax treatment (and therefore arrangements that lower a group's worldwide tax obligations), which is an important part of identifying a hybrid mismatch arrangement under the proposals. **Range of options considered** Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations. **Assumptions underpinning impact analysis** The estimated impact of the options is dependent on the behavioural response of taxpayers to the introduction of some form of hybrid mismatch arrangement rules. Taxpayers may rearrange their affairs to fall outside the scope of any proposed rules, which will have flow-on effects as to efficiency, compliance costs and revenue implications. Beyond anecdotal information learned through consultation, it is difficult to assess the extent and nature of the behavioural response.
Responsible Manager (signature and date):
Paul Kilford Policy Manager, Policy and Strategy Inland Revenue 12 July 2017

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

BEPS

Base erosion and profit shifting (BEPS) refers to the aggressive tax planning strategies used by some multinational groups to pay little or no tax anywhere in the world. This outcome is achieved by exploiting gaps and mismatches in countries' domestic tax rules to avoid tax. BEPS strategies distort investment decisions, allow multinationals to benefit from unintended competitive advantages over more compliant or domestic companies, and result in the loss of substantial corporate tax revenue. More fundamentally, the perceived unfairness resulting from BEPS jeopardises citizens' trust in the integrity of the tax system as a whole.

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of 15 recommended tax measures for countries to implement to counter base erosion and profit shifting (BEPS).

Hybrid mismatch arrangements

Hybrid mismatch arrangements arise when taxpayers exploit inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. The OECD's BEPS package includes Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. Hybrid mismatch arrangements are prevalent worldwide and are an important part of the base erosion and profit shifting strategies used by multinational companies. If no action is taken by the international community to counter these types of arrangements they are likely to continue to be used to avoid worldwide taxation and drive economic inefficiencies and unfairly distributed tax burdens.

New Zealand's BEPS work

The New Zealand Government has signalled a willingness to address BEPS issues and has taken tangible action in this regard. New Zealand is a supporter of the OECD/G20 BEPS project to address international tax avoidance and is advancing a number of measures that are OECD/G20 BEPS recommendations.

In September 2016 the Government released a BEPS discussion document: *Addressing hybrid mismatch arrangements* which proposed adoption of the OECD Action 2 recommendations in New Zealand and sought submissions on how that should be done. In March 2017 the Government released two further discussion documents: *BEPS – Strengthening our interest limitation rules*; and *BEPS – Transfer pricing and permanent establishment avoidance*.

As part of Budget 2017, the Government decided to proceed with tax law changes to implement one aspect of the hybrid rules. This change is to restrict the ability of New Zealand businesses to use double deductions of foreign hybrid entities to reduce their tax liabilities in New Zealand. This restriction is intended to apply to the most prevalent hybrid structure involving outbound investment by New Zealand based groups, which is the use of financing through Australian limited partnerships to achieve double deductions.

At the same time, Cabinet noted that the reforms proposed in the BEPS documents would be progressed, subject to modification in consultation, for implementation from 1 July 2018. Cabinet also noted that officials are continuing to develop and consult on all aspects of the BEPS project and that Cabinet approval will be sought for final policy decisions later in 2017.

2.2 What regulatory system, or systems, are already in place?

New Zealand's tax system

New Zealand has a broad-base, low-rate (BBLR) taxation framework. This means that tax bases are broad and tax rates are kept as low as possible while remaining consistent with the Government's distributional objectives. The BBLR framework also means that the tax system is not generally used to deliver incentives or encourage particular behaviours.

Company tax and international rules

The company tax system is designed to be a backstop for taxing the personal income of domestic investors. Company tax is deducted at 28%, but New Zealand based investors can claim imputation credits for tax paid by the company when the income is taxed upon distribution at the personal level. At the same time, the company tax is designed as a final tax on New Zealand-sourced income of foreign investors and foreign-owned companies earning New Zealand-sourced income.

Having a consistent tax framework such as BBLR does not mean that tax changes are unnecessary. An ongoing policy challenge in the area of international tax is to ensure that multinational firms pay a fair and efficient amount of tax in New Zealand. Anti-avoidance rules and base protection measures are important part of ensuring that New Zealand collects an appropriate amount of tax on non-resident investment.

At the same time, it is important that New Zealand continues to be a good place to base a business and that tax does not get in the way of this happening. New Zealand relies heavily on foreign direct investment (FDI) to fund domestic investment and, as such, the Government is committed to ensuring New Zealand remains an attractive place for non-residents to invest.

2.3 What is the policy problem or opportunity?

The problem of hybrid mismatch arrangements

Businesses can use hybrid mismatch arrangements to create tax advantages through exploiting inconsistencies in the way that jurisdictions treat financial instruments and entities under their respective domestic law. For example, using a hybrid entity or a foreign branch, a single expense may be deducted in two different jurisdictions, potentially reducing the tax payable on two different streams of income. Another example is a payment that is tax-deductible in one jurisdiction with no corresponding taxable income in the jurisdiction where the payment is received. However it is achieved, the result of a hybrid mismatch arrangement is less aggregate tax revenue collected in the jurisdictions to which the arrangement relates when compared with a straightforward arrangement that is seen consistently by both relevant countries. Hybrid mismatch arrangements also have the effect of subsidising international investment relative to domestic investment, which distorts the efficiency of global markets.

Since releasing its final recommendations on hybrid mismatch arrangements, the OECD expanded the scope of BEPS Action 2 to include branch mismatches. Branch mismatch arrangements are a result of countries approaching the allocation of income and expenses between a branch and a head office in different ways. Branch mismatch arrangements can also result in a reduction in the overall taxation of a corporate group, so are similar in effect to hybrid mismatch arrangements.

It is important to note that the policy problem is limited to circumstances when global tax is reduced as a result of a hybrid mismatch. This project does not address other mechanisms that taxpayers may use to lower their global tax liability, such as the use of low-tax jurisdictions to trap income.

Hybrid mismatch arrangements in New Zealand

New Zealand has a general anti-avoidance rule (GAAR) that can, in some instances, neutralise the effects of a hybrid mismatch arrangement. However, the target of the GAAR is arrangements that avoid New Zealand tax. The arrangement must also do so in a manner that is outside Parliament's contemplation; a classic indicator being that the arrangement gains the advantage in an artificial or contrived way. Although the use of a hybrid mismatch arrangement reduces the overall tax paid by the parties to the arrangement, it is often difficult to determine which country involved has lost tax revenue. Further, the use of a hybrid is not necessarily artificial or contrived in and of itself. Accordingly, the GAAR does not provide a comprehensive solution to counter the use of hybrid mismatch arrangements.

New Zealand also has some specific rules in its domestic law that go some way to addressing particular recommendations made by the OECD in relation to hybrid mismatch arrangements.

Inland Revenue is aware of a significant volume of hybrid mismatch arrangements involving New Zealand. For example, the amount of tax at issue in recent litigation for a prominent type of hybrid financial instrument was approximately $300 million (across multiple years). In relation to hybrid entities, deductions claimed in New Zealand that are attributable to the most prominent hybrid entity structure results in approximately $50 million less tax revenue for New Zealand per year.

2.4 Are there any constraints on the scope for decision making?

Our analysis has been constrained by the scope and nature of the OECD's work on hybrid mismatch arrangements. For reasons of international compatibility it would be unwise for New Zealand to design a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This limitation has been mitigated to a certain extent by New Zealand's ongoing involvement in the development of the OECD recommendations.

Consistent with the OECD approach, the analysis has been focused on arrangements between related parties or where a hybrid mismatch has been created through a structured arrangement between unrelated parties.

We have also chosen to restrict the policy thinking to cross-border activity. Purely domestic hybrid mismatches (some of which are contemplated by the OECD Action 2 final report) are outside the scope of this regulatory proposal.

2.5 What do stakeholders think?

Stakeholders

Stakeholders of this regulatory proposal are primarily taxpayers (typically multinational businesses that have hybrid mismatch arrangements) and tax advisors. The proposed rules will be applied to taxpayers' affairs, while tax advisors will assist (taxpayer) clients as to the application of the proposed rules. The proposed rules affect only taxpayers with foreign

connections – that is, foreign-owned New Zealand taxpayers, and New Zealand-owned taxpayers with foreign operations.

Another stakeholder of this regulatory proposal is the OECD, which is aiming to eradicate hybrid mismatch arrangements to the extent possible. This goal can only be achieved through countries adopting hybrid mismatch rules of some kind and neutralising the mismatches that arise when different sets of rules apply to the same transaction or entity. In addition, other countries that have enacted or are proposing to enact hybrid mismatch rules (for example, Australia and the United Kingdom) will be interested in the interaction between their own hybrid mismatch rules and any rules that New Zealand introduce into law.

The Reserve Bank of New Zealand (RBNZ) is interested in the regulatory proposal to the extent that it affects bank regulatory capital.

Submissions to discussion document

There were 20 submissions made to the September 2016 Government discussion document. Submissions varied significantly in responding to the proposals both in general views and specific coverage. Some submitters were supportive of New Zealand taking action in line with the OECD hybrids package, subject to various provisos including that it was done in a co-ordinated fashion with other jurisdictions and/or that there should be concessions of some variety. However, a greater number of submitters were in favour of adopting a targeted or phased approach to the OECD hybrids package focused on countering hybrid arrangements that are of most concern to New Zealand.

Submissions also covered a number of specific aspects of, and general concerns with, the proposals, including the complexity of the proposals and that New Zealand should not be in the first wave of countries adopting the proposals.

Further and ongoing consultation

We have engaged in approximately a dozen workshops (with the Corporate Taxpayers Group and Chartered Accountants Australia and New Zealand) and attended various other meetings with private sector submitters (including the New Zealand Bankers' Association) in order to discuss specific design issues relating to hybrid mismatch arrangements.

We have also consulted with officials representing Australia and the United Kingdom, as well as the OECD secretariat, on an ongoing basis to ensure that the proposed rules work as intended, and do not give rise to inadvertent double taxation or non-taxation.

We have also consulted with the Reserve Bank.

The Treasury has been heavily involved with the policy development process in their joint role with Inland Revenue as tax policy advisors for the Government.

Section 3: Options identification

3.1 What options are available to address the problem?

Four options were considered in the development of this regulatory proposal. These options are mutually exclusive and can be regarded as four points on a decision spectrum measuring how closely (if it all) New Zealand aligns itself with the OECD recommendations in dealing with hybrid mismatch arrangements.

None of the options (with the exception of the status quo option) are non-regulatory options. This is because our judgment is that the policy problem of hybrid mismatch arrangements cannot be addressed without changing tax rules, and that is something that can only be done through the use of legislation (as per section 22(a) of the Constitution Act 1986).

These options are what we consider other countries dealing with hybrid mismatch arrangements will consider in their policy development process. The United Kingdom and Australia can both be said to have chosen their own version of option 2. Some other countries have had rules to deal with hybrid mismatches that predate the OECD's work in this area.

Status quo: No action

This option relies on New Zealand's existing law (including the GAAR) to counter hybrid mismatch arrangements and avoids the increased compliance costs and administrative costs of the other options. The status quo option also contemplates that other countries have introduced or will introduce their own hybrid mismatch rules, some of which will neutralise hybrid mismatch arrangements relating to New Zealand.

Option 1: Strict adoption of OECD recommendations

The OECD recommendations as set out in its BEPS Action 2 report are a comprehensive set of principle-based rules to counteract all types of hybrid mismatch arrangements. Option 1 is to strictly adopt those recommendations as described by the OECD into New Zealand domestic law. This option would deal with the range of hybrid mismatch arrangements targeted by the OECD to the extent they are found in or affect New Zealand. It would have the advantage of interacting well with other countries that similarly adopt the OECD recommendations into their domestic law.

Option 2: Tailored adoption of OECD recommendations

Option 2 is to adopt the core principles of the OECD recommendations with suitable modifications and variations to take into account what is appropriate for the New Zealand context. This option bears close relation to Option 1 as it involves introducing OECD-consistent hybrid rules unless there is a compelling reason to depart from the OECD approach. Thus, this option would solve the policy problem while ensuring that particular New Zealand issues are addressed.

Option 2 also recognises that there are some instances where New Zealand's existing tax laws are sufficient (or can be made sufficient with relatively minor amendment) to achieve the effect intended by an OECD recommendation.

Option 3: Targeted hybrid rules

Option 3 is to introduce targeted hybrid rules that address only the significant hybrid mismatches that the Government is aware of. This option would solve the policy problem by addressing the current hybrid mismatch arrangements affecting New Zealand. It would avoid

enacting rules targeted at arrangements which are not currently seen in New Zealand.

Consultation

These four options were identified prior to consultation. The September 2016 discussion document proposed adoption of the OECD recommendations (options 1 and 2) and sought feedback on how that should be done. The document stated the Government's alternative options as option 3 and maintaining the status quo and concluded that they were not the best way forward. Consultation has affected the nature of option 2 in particular and has been helpful for options analysis generally.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- Efficiency of compliance – compliance costs for taxpayers should be minimised as far as possible
- Efficiency of administration – administrative costs for Inland Revenue should be minimised as far as possible
- Neutrality – the tax system should bias economic decisions as little as possible
- Fairness and equity – similar taxpayers in similar circumstances should be treated in a similar way
- Sustainability – the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved

In relation to this regulatory proposal, it would be difficult to achieve positive sustainability, neutrality and fairness impacts without some increase in compliance costs and so there are some trade-offs that were and continue to be considered. Through our consultation we have worked with stakeholders to minimise compliance costs as much as possible without sacrificing the benefits of the proposal.

3.3 What other options have been ruled out of scope, or not considered, and why?

We ruled out designing a largely unique set of hybrid mismatch rules that departs from the principles that the OECD has advocated for. This is for reasons of international compatibility and to save compliance costs.

Section 4: Impact Analysis

	Status quo: No action	Option 1: Strict adoption	Option 2: Tailored adoption	Option 3: Targeted rules
Efficiency of compliance	0	- - Option 1 has a significant compliance burden because some of the OECD recommendations as drafted would not mesh well with New Zealand's existing tax laws.	- Option 2 imposes increased compliance costs on taxpayers and advisors, but is focused on reducing those costs where possible.	- Option 3 imposes increased compliance costs on taxpayers and advisors, but by its nature it reduces those costs in proposing rules that only address currently observed exploitation of hybrid mismatches.
Efficiency of administration	0	0 We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	0 We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.	0 We expect the additional costs to Inland Revenue of administering a tax system with hybrid mismatch rules to be balanced by less resources used disputing hybrid mismatch arrangements using the GAAR.
Neutrality	0	++ Option 1 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	++ Option 2 will comprehensively remove the benefit of hybrid mismatch opportunities involving New Zealand. This will provide significant efficiency gains.	+ Option 3 will remove the tax benefit of currently observed hybrid mismatch opportunities involving New Zealand. This will likely provide some efficiency gains. However, other hybrid mismatch arrangement opportunities will remain available. This means that, depending on the extent to which taxpayers respond to an option 3 approach by simply moving into "uncovered" tax-efficient hybrid structures, there will still be some inefficient allocations of investment due to ongoing hybrid mismatch arrangements.
Fairness and equity	0	+ Option 1 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 2 has fairness and equity benefits as it ensures that taxpayers able to use hybrid mismatch arrangements cannot reduce their tax liability.	+ Option 3 has fairness and equity benefits as it ensures that taxpayers able to use currently observed hybrid mismatch arrangements cannot reduce their tax liability. However, this option's fairness impact depends on the behavioural effects of introducing these rules to a greater extent than options 1 and 2.
Sustainability	0	++ Option 1 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	++ Option 2 will remove current and future hybrid mismatch arrangement opportunities involving New Zealand.	+ Option 3 will remove currently known hybrid mismatch arrangement opportunities involving New Zealand. However, this option's sustainability is limited. It will leave some hybrid mismatches unaddressed, which may be exploited at a later date by opportunistic taxpayers.
Overall assessment	Not recommended	Not recommended	**Recommended**	Not recommended

Key:

++ much better than doing nothing/the status quo
+ better than doing nothing/the status quo
0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- - much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

We consider that option 2 is the best option for addressing the problem of hybrid mismatch arrangements. It is an internationally consistent, proactive option which delivers net benefits to New Zealand greater than that of the other options considered.

Option 2 will improve the neutrality of New Zealand's tax system. Businesses that are able to exploit hybrid mismatch arrangements can currently operate at lower effective tax rates when compared with other businesses. This can result in a 'hybrid' business crowding out more productive investment and making international investment decisions based on whether a mismatch is available rather than commercial grounds. In addition, the imposition of higher taxes elsewhere in order to make up lost tax revenue due to the use of hybrid mismatches is likely to be less efficient than imposing more moderate taxes across all economic actors. By eliminating the tax benefit of hybrid mismatch arrangements in a comprehensive way, these inefficiencies can be removed.

In a related sense, option 2 will help to improve the equity and fairness of the New Zealand tax system. Unintended tax benefits that are streamed to some taxpayers who are able to take advantage of hybrid mismatches means that a greater tax burden must fall on other taxpayers (such as purely domestic firms) who do not have the hybrid mismatch opportunities that cross border businesses do. Accordingly, introducing rules to counter hybrid mismatch arrangements will restore some fairness to the tax system as those tax burdens will be shared more equally.

Option 2 will also have revenue collection benefits. The New Zealand tax revenue loss caused by the use of hybrid mismatch arrangements is difficult to estimate because the full extent of arrangements involving New Zealand is unknown and because the behavioural effects of introducing hybrid mismatch rules are difficult to ascertain. However, the tax revenue at stake is significant in the cases that Inland Revenue is aware of.

Importantly, the case for New Zealand to adopt the OECD recommendations is strengthened by the fact that other countries have enacted, or are proposing to enact, hybrid mismatch rules. This is because a hybrid mismatch arrangement involving a New Zealand counterparty may still be neutralised by the other country if they have a 'secondary' right to counteract under OECD principles. In that case, the tax benefit of the hybrid mismatch would be eliminated, but the tax collected would be by the counterparty country. In these circumstances, New Zealand would be better off having its own hybrid mismatch rules so that it can collect revenue when it has the priority to do so under the OECD recommendations. Whether New Zealand or the counterparty country collects any additional revenue as a result of implementing the rules depends on the actions taken by the affected business.

Option 2 is ultimately a balance between the positive impacts described above and the trade-off compliance costs. It attempts to introduce a comprehensive set of rules which is adjusted for the New Zealand tax environment. For instance, we identified early in the policy development process that one of the OECD recommendations would not interact smoothly with New Zealand's approach to the taxation of the foreign branches of New Zealand companies. The recommendation in question had to be modified under option 2 so that the tax treatment of a simple offshore branch structure of a New Zealand company (which is not part of the policy problem) would be unaffected by the introduction of the hybrid mismatch

rules. We have also recommended a delay to the effective date of an OECD-recommended rule which applies to what are known as “unstructured imported mismatches”. This rule could cause undue compliance costs if it was to come into effect at the same time as the other rules. Delaying its effective date until a significant number of other countries have introduced hybrid mismatch rules means the associated New Zealand-specific compliance costs will either disappear or will be no greater than the costs faced by a multinational group operating in those other countries.

Accordingly, the compliance costs of the regulatory proposal are to be minimised to the extent possible, while still introducing a comprehensive set of rules to deal with the range of OECD-identified hybrid mismatches. This is where option 2 shows its advantage over option 1 which we view as having similar efficiency, fairness and revenue benefits. Option 1 would result in relatively higher compliance costs because the OECD recommendations are designed as a general set of best-practice rules and, in regards to their detail, are not necessarily optimal for individual countries such as New Zealand. When compared with option 1, option 2 ensures that the rules are workable and appropriate for the New Zealand tax environment.

It is also important to note that the ongoing compliance costs relating to this regulatory issue are expected to be optional in the majority of cases. The proposed rules will apply to taxpayers who use a hybrid mismatch arrangement after the rules become effective. Those taxpayers will generally have the option of incurring one-off costs to restructure into non-hybrid arrangements and remove themselves from the scope of the proposed rules.

Any higher tax payments resulting from the non-status quo options will make cross border investment less attractive for taxpayers using hybrid mismatch arrangements. However, these taxpayers should not be allowed to exploit hybrid mismatches to achieve a competitive advantage over taxpayers that do not use hybrid mismatch arrangements (such as purely domestic firms). Further, a significant number of New Zealand’s major investment partners have introduced or will introduce hybrid mismatch rules. Other countries adopting these rules means that in many cases the tax efficiency of hybrid mismatch arrangements in New Zealand will be negated through the operation of the other country’s rules on the counterparty, As a result, we believe that any impacts on inbound and outbound cross border investment from introducing hybrid mismatch rules in New Zealand will be low.

The status quo option would involve the least complexity and lowest compliance costs. However, similar to the cross-border investment discussion above, taxpayers whose groups deal with New Zealand’s major trading partners that are adopting hybrid mismatch rules would have to understand the impact of those rules. The additional complexity of New Zealand having hybrid mismatch rules would therefore be lessened by the international momentum in this area.

Option 3 is an option that was preferred by many submitters to the Government discussion document on hybrid mismatch arrangements. Submitters pointed out that many of the structures considered by the OECD to be problematic have not been seen in New Zealand and therefore do not need to be counteracted. They also argued that the OECD recommendations are complex and have the potential for overreach. We do not think a targeted approach would serve New Zealand well when compared with option 2. The OECD recommendations are a coherent package intending to deal to the problem of hybrid mismatch arrangements exhaustively. Deliberately omitting aspects of the recommendations from New Zealand’s response may cause taxpayers to exploit those remaining hybrid mismatch opportunities (which may even be seen as tacitly blessed). To the extent that happens, the efficiency, revenue, and fairness benefits of option 3 would be eroded. In

addition, other countries such as the United Kingdom and Australia have introduced or are intending to introduce a relatively comprehensive set of hybrid mismatch rules. If New Zealand does the same it will ensure our rules are internationally comparable and that they interact well with the rules of other countries without significant compliance issues. By favouring option 2, we also have consulted extensively on the OECD recommendations and how they should best be introduced into New Zealand law. This consultation has enabled us to design suitable modifications to the OECD recommendations to reduce complexity and compliance costs, limit overreach, and in some cases, increase the efficiency of the outcomes.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	Compliance costs: Increased costs from understanding the rules and applying them to taxpayers' transactions and structures. Or, restructuring costs of transitioning to non-hybrid arrangements to fall outside the scope of the rules.	Medium	Medium
	Tax payable: Foreign hybrid entity double deduction structures are included in the rules and we are confident of collecting a significant amount of revenue from the disallowance of that type of hybrid mismatch arrangement.	Approximately $50 million per year on an ongoing basis	Low*
Regulators	Administrative costs: Inland Revenue staff, particularly investigations staff, need to develop their knowledge of the hybrid mismatch rules.	Low	High
Wider government			
Other parties			
Total Monetised Cost	Tax payable	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised	Compliance costs	Medium	Medium

costs	Administrative costs	Low	High

Expected benefits of proposed approach, compared to taking no action			
Regulated parties			
Regulators	Revenue: Revenue collected from tax payable item described above.	Approximately $50 million per year on an ongoing basis	Low*
	Reduced administrative costs: Less investigations and disputes resources spent on hybrid mismatch arrangements using the general anti-avoidance law (GAAR).	Low	High
Wider government			
Other parties			
Total Monetised Benefit	Revenue	Approximately $50 million per year on an ongoing basis	Low*
Non-monetised benefits	Reduced administrative costs	Low	High

*Note that the evidence for the $50 million figure is strong, but it is a conservative estimate made in light of the behavioural uncertainty associated with introducing hybrid mismatch rules together with the fact that the full extent of hybrid mismatch arrangements affecting New Zealand is unknown. The actual revenue generated from these reforms may therefore be higher, but this cannot be estimated with confidence.

5.3 What other impacts is this approach likely to have?

As discussed above, allowing the use of hybrid mismatch arrangements is inefficient and unfair, as it results in uneven tax burdens across different businesses. This is an issue in itself, but it may also weaken taxpayer morale. The perception of unfairness that comes from the reported low corporate taxes paid by taxpayers who can take advantage of hybrid mismatch opportunities (and/or employ other BEPS strategies) is an important issue. This perception of unfairness undermines public confidence in the tax system and therefore the willingness of taxpayers to voluntarily comply with their own tax obligations. This integrity factor is difficult to assign to a particular set of stakeholders as it is something that is fundamental to the tax system itself.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Yes, option 2 (tailored adoption of OECD recommendations) conforms to the expectations for the design of regulatory systems document.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred option will be given effect through amendments to the Income Tax Act 2007 and the Tax Administration Act 1994. The bill, when introduced, will be accompanied by commentary in order to provide stakeholders with guidance as to the intended application of the provisions. Inland Revenue will also produce guidance on the enacted legislation in its Tax Information Bulletin (TIB).

Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules. Inland Revenue has not identified any concerns with its ability to implement these reforms.

The intended application date for most aspects of the regulatory proposal is for income years starting on or after 1 July 2018. The major exceptions are:

- the proposed rule for "unstructured imported mismatch arrangements", which we recommend be delayed until income years starting on or after 1 January 2020; and
- the proposed rules applying to New Zealand "reverse hybrids", which we recommend be delayed until income years starting on or after 1 April 2019.

Another exception we recommend is a grandparenting rule that exempts from application of the rules (until the next call date) hybrid financial instruments issued by banks as regulatory capital (in Australian or New Zealand) to third party investors before the discussion document release date of September 2016.

Some submitters on the discussion document argued that there needs to be sufficient lead-in time for these reforms to allow taxpayers to restructure their affairs if necessary. We consider an application date of 1 July 2018 (for most of the measures) to be sufficiently prospective when compared with the date of the discussion document release, which is when taxpayers should be regarded to be have been notified of the Government's intention in this area, and the scheduled date of introduction of the relevant tax bill.

6.2 What are the implementation risks?

We do not consider there to be many implementation risks for Inland Revenue. Audit staff will need to familiarise themselves with the proposed rules and how they operate in practice. As with any legislative proposal, there is the risk of technical drafting errors and unintended consequences. If and when these arise, they will be dealt with by remedial amendment.

In practice, these reforms will mostly involve changes for taxpayers rather than Inland Revenue. There is a risk that some taxpayers may not be able to restructure their hybrid mismatch arrangements or understand the rules in time to comply with their new obligations. To manage this risk, we are minimising compliance costs where possible under our tailored adoption of the OECD recommendations. For example, and as mentioned above, we have delayed the application date of the unstructured imported mismatch rule contained in the OECD recommendations to acknowledge that it would be significantly more difficult and costly to comply with than the other rules if it applied at the outset.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

Existing investigations functions for monitoring the behaviour of taxpayers will continue to be used for the proposed rules of this regulatory proposal.

However, it may be difficult to assess the true impact of this regulatory proposal. This is because many taxpayers using hybrid mismatch arrangements may rearrange their affairs to fall outside the scope of the proposed rules. It will be difficult to measure the full extent of this behavioural effect.

Inland Revenue are currently considering the appropriate level of information that should be collected to support the proposed rules for this regulatory proposal and for other BEPS proposals. This may be in the form of a disclosure statement made to the Commissioner of Inland Revenue or it may form part of existing information gathering tools.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. For example, a post-implementation workshop with stakeholders that participated in policy consultation sessions may be appropriate for these rules. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

If it became apparent that an aspect of the proposed rules is unworkable, or if the rules have created unintended consequences whether tax-related or otherwise, this would justify a review of all or part of the legislation.