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Tax Insights

Hybrid Mismatch Exposure Draft

Snapshot

On 7 March 2018, the Australian Government released revised Exposure Draft (**ED**) legislation addressing hybrid mismatch arrangements. The revised draft is an updated version of the November 2017 release covered by our earlier Tax Insights publication available here. Among other additions and changes, the revised draft incorporates the branch mismatch rules and the targeted integrity rule promised in previous Government announcements.

Timing

The ED Explanatory Memorandum (**EM**), like its November 2017 predecessor, indicates that the proposed new anti-hybrid rules will apply to payments made on or after the date that is 6 months after Royal Assent. However, the revised ED legislation has omitted some of the application provisions.

Subject to seeing the final application and transitional provisions, our current expectation, based on the Australian Parliament Sitting Calendar, is

that a start date affecting payments made in 2018 is now relatively unlikely.

Targeted integrity rule (TIR)

The TIR was foreshadowed in the November 2017 release and is intended to "*prevent the effect of the hybrid mismatch rules … from being compromised by multinational groups using interposed conduit type entities that pay effectively no tax to invest into Australia*". The ED EM indicates that the primary focus of the TIR is on intra-group financing arrangements within multinational groups where funds are routed through interposed entities resulting in an Australian tax deduction (e.g. for interest on a "vanilla" loan) and imposition of foreign income tax on the payment at a rate of 10% or less. Although included as part of the ED legislation, the TIR is not strictly an anti-hybrid measure and goes beyond the Action 2 measures proposed by the OECD.

Briefly, the TIR may apply where the following are met:

- A payment of interest, or amounts under "derivative financial arrangements" which are (but for this rule) deductible in Australia
- The payment is to an interposed foreign entity, including under certain 'back-to-back' arrangements
- The interposed foreign entity must be part of the same "control group" as both the paying entity and the ultimate parent of the group
- The interposed foreign entity is not tax resident in that ultimate parent's jurisdiction
- The payment is "subject to foreign income tax" in the interposed entity's country at a rate of 10% or less.

Where the conditions are met, unless one of the below 3 exceptions applies, the TIR will deny the paying entity an Australian income tax deduction in respect of the payment.

The TIR will not apply where it is reasonable to conclude that either:

1. **CFC exception**: the payment is taxable under Australia's controlled foreign company (**CFC**) rules, or included in working out the tax base of an entity under a corresponding law of a foreign country; or
2. **Low taxed parent exception**: the payment, had it been made directly to the ultimate parent, would have been subject to foreign income tax at a rate no higher than the interposed country rate, and would not have given rise to certain specified hybrid mismatches; or
3. **"Designed to produce" exception**: the scheme under which the payment was made was **not** designed to produce both a deduction for the payment and the imposition of foreign tax on the payment at a rate of 10% or less. The phrase "designed to produce" resembles concepts used in section 974-80(1)(d) of the 1997 Act[1], the application of which in practice has given rise to numerous challenges. The ED EM indicates that the relevant factors in considering this term include whether the interposed foreign entity undertakes a group financing function or acts as a regional holding company, and carries on substantial economic activities.

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[1] References to "1997 Act" are to the *Income Tax Assessment Act 1997* and references to the "1936 Act" are to the *Income Tax Assessment Act 1936*.

Branch mismatch rules

The ED legislation implements the recommendations of the OECD report *Neutralising the Effects of Branch Mismatch Arrangements*. Branch mismatches arise where rules for allocating income and expenditure between a branch and head office result, due to different tax treatments in each jurisdiction, in a portion of the taxpayer's net income not being taxed in either the branch or head office jurisdiction.

The ED legislation proposes to include new Subdivision 832-F in the 1997 Act to neutralise "branch hybrid mismatches" involving deductions in Australia. An entity is a "branch hybrid" in relation to a payment where, in broad terms, the head office jurisdiction applies a branch profits exemption but the branch jurisdiction fails to tax the payment. Although the rules are complex, in summary, a payment to a branch hybrid under a structured arrangement or within the same control group will result in a "branch hybrid mismatch" to the extent that the payment gives rise to a deduction/non-inclusion outcome that would not have arisen had the head office jurisdiction not recognised the permanent establishment in the branch country. The effect of Subdivision 832-F is to deny an Australian income tax deduction in respect of such payments.

The ED legislation also proposes to amend the 1936 Act to limit the scope of the exemption for foreign branch income and prevent a deduction for certain payments by an Australian branch of a foreign bank to its head office. Briefly:

1. The exemption currently provided to Australian companies under section 23AH for certain foreign branch income will no longer apply to payments under structured arrangements or within a control group that are not subject to foreign income tax in the branch country because they are regarded as not having been derived in carrying on business through a permanent establishment there; and

2. The deduction currently provided under Part IIIB of the 1936 Act to an Australian branch of a foreign bank for notional payments of interest, or under notional derivative transactions, made to the foreign bank will no longer be available in certain circumstances, depending on factors such as whether the notional payment is subject to foreign income tax.

Other updates

The ED legislation also includes various other updates to the November 2017 release, including provisions dealing with:

- Interaction between the hybrid mismatch rules and the taxation of financial arrangements (**TOFA**) rules
- Calculating the attributable income of a CFC and ensuring that the hybrid mismatch rules are disregarded for such purposes
- Currency exchange rate effects
- Effect of foreign 'dividends received deductions' (**DRD**s)
- Foreign equity distributions received by CFCs, or from certain foreign corporate collective investment vehicles.

Action

The proposed rules are expected to impact the tax outcomes arising from many arrangements currently in place. There are no grandfathering rules. Whilst it may be obvious to taxpayers that hybrid mismatch arrangements will need to be reviewed and potentially unwound, the TIR also means that many normal cross border loan arrangements will need to be tested (including reviewing upstream or potential back to back arrangements) to test whether the TIR may extinguish deductions for existing loans.

Taxpayers should consider the potential application of the rules to their funding and operational structures and the associated tax, financial reporting, legal and treasury issues which may arise – including the potential need to refinance or restructure existing arrangements.

In conjunction with the ED release, Treasury has announced a new consultation process covering the revised ED legislation in its entirety and not limited to the branch mismatch and targeted integrity rules. Deloitte will be part of this consultation process, and submissions are due by 4 April 2018.

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