Deloitte.

22 June 2018
Australia 2018/12

Tax Insights

Hybrid Mismatch and Multinational Group Financing Integrity Rules

Snapshot

On 21 June 2018, the Australian Taxation Office (**ATO**) released draft Practical Compliance Guideline PCG 2018/D4 (**draft PCG**) setting out the ATO's proposed compliance approach with respect to the potential application of Australia's general anti-avoidance rule (**Part IVA**) to restructures of hybrid mismatch arrangements. The draft PCG follows the introduction into Australian Parliament on 24 May 2018 of measures addressing hybrid mismatch arrangements, together with a targeted integrity rule, as part of the *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018*. In this Tax Insights we outline the key takeaways from the draft PCG and the proposed measures in the Bill.

Draft PCG 2018/D4

The draft PCG is intended to assist taxpayers manage compliance risk with respect to Part IVA where existing hybrid arrangements are restructured to avoid potential application of the hybrid mismatch rules (e.g. replacing a hybrid financing instrument with a debt instrument to eliminate tax benefits in another country but preserve tax benefits, in the form of deductible debt, in Australia). The draft PCG indicates that a replacement arrangement generally will be considered "low risk" for purposes of Part IVA where the restructure merely removes the hybrid mismatch outcome and the arrangement is itself an ordinary commercial dealing without contrived features that would attract Part IVA. Where a tax benefit in Australia involves deductions, the ATO will expect to see that any corresponding income is subject to tax in the other country (and no deduction for the same payment is available in another country) and, conversely, where the tax benefit in Australia takes the form of non-inclusion of assessable income, then the ATO will expect to see that a deduction is not available in the other country.

The draft PCG identifies a number of low risk scenarios, all of which have the following features:

- No change to the jurisdictions of the entities involved
- The restructure and replacement arrangement are effected in a straightforward way having regard to the circumstances, and are implemented on arm's length terms
- The original arrangement makes commercial sense for the parties and would not have attracted Part IVA
- The replacement arrangement makes commercial sense for the parties and, disregarding the potential application of Part IVA, preserves a tax benefit

The low risk scenarios include replacement of inbound mandatorily redeemable preference shares with an ordinary interest bearing shareholder loan (eliminating a "deduction/non-inclusion" mismatch), and the replacement of an outbound profit participating loan with ordinary equity (eliminating a "deduction/non-inclusion" mismatch).

The draft PCG indicates that the presence of features inconsistent with the above list may indicate a higher compliance risk, and outlines certain higher risk scenarios where removing the hybrid element of an arrangement "*will not preclude scrutiny of the arrangement if it is one that otherwise has features of artificiality or contrivance giving rise to Part IVA … considerations*". The higher risk scenarios include replacement of inbound mandatorily redeemable preference shares with an interest bearing loan from an interposed foreign entity in a low tax jurisdiction, in circumstances that would also potentially attract the operation of the "targeted integrity rule" in any case (see below).

The draft PCG is expressed to become effective from the date of enactment of the hybrid mismatch rules and to apply to restructuring arrangements entered into before and after that date (with continuous review over the following three years).

Deloitte will be participating in the consultation process in relation to the draft PCG, submissions for which are due 20 July 2018.

Hybrid Mismatch Measures

The measures in the Bill are substantially in line with the previously released Exposure Draft legislation covered by our earlier Tax Insights publications available here. However, the measures in the Bill include a number of additions and modifications, some of which reflect submissions made by Deloitte as part of the consultation process.

Commencement

The proposed measures, generally, will apply to assessments for income years starting on or after 1 January 2019. However, the imported hybrid mismatch rule will only apply from this date in the context of structured arrangements; otherwise it will apply for income years starting on or after 1 January 2020. Given the broad definition of "structured arrangements", this deferred start date might only be available in limited circumstances.

Therefore, taxpayers with a 30 June year end should prepare for potential application of the general rules from 1 July 2019. However, taxpayers with a substituted accounting period may need to prepare for earlier application, potentially from 1 January 2019.

The proposed specific measures denying Australian imputation benefits or the Australian participation exemption in respect of certain distributions giving rise to foreign income tax deductions will apply to distributions made on or after 1 January 2019, other than in respect of some Additional Tier 1 capital instruments.

Hybrid Mismatch Rules

As expected, the hybrid mismatch rules contained in the Bill are largely in line with the OECD BEPS Action 2 recommendations, including some Australian-specific adoptions such as denial of imputation benefits in certain circumstances.

In broad terms, a hybrid mismatch will arise under the proposed rules if a payment gives rise to:

- A ***deduction/non-inclusion mismatch*** (*e.g.* a deduction for a payment is allowed in the payer's jurisdiction, but is not included in assessable income in the recipient's jurisdiction); or
- A ***deduction/deduction mismatch*** (*e.g.* a deduction is available for the same payment in two jurisdictions).

Importantly, the rules apply where the above outcomes arise in respect of "control groups" or "structured arrangements" for the following mismatches:

- A ***hybrid financial instrument mismatch*** (*e.g.* deductible payment under a financial instrument, but non-inclusion for the recipient, and this is attributable to differences in the treatment of the financial instrument between jurisdictions);
- A ***hybrid payer mismatch*** (*e.g.* deductible payment under an arrangement, but the receipt is disregarded in the hands of the recipient, and this is due to differences in the treatment of the payer between jurisdictions);

- A ***reverse hybrid mismatch*** (*e.g.* deductible payment under an arrangement, but the receipt is not included as income in the jurisdiction in which the recipient is established, and this is due to differences in the treatment of the recipient and its owner between jurisdictions);
- A ***branch hybrid mismatch*** (*e.g.* deductible payment under an arrangement, but the receipt is not included as income in the jurisdictions in which the recipient is established or has a permanent establishment);
- A ***deducting hybrid mismatch*** (*e.g.* a payment made by an entity, such as a dual resident, where a deduction is taken into account in two or more jurisdictions); or
- An ***imported hybrid mismatch*** (*e.g.* a payment is included in income, but off-set directly against a deduction that arises under a hybrid mismatch arrangement in an offshore jurisdiction, say, by the use of an interposed foreign entity).

A mismatch which is covered by the proposed rules will be "neutralised" either by disallowance of a deduction or, alternatively, inclusion of an amount in assessable income.

The following specific changes between the exposure draft legislation and the Bill should be noted:

- A *deducting hybrid mismatch* should now only arise where the deducting entity is a "liable entity" (*i.e.* in broad terms, subject to income tax) in at least one of the countries in which deductions arise. This should assist Australian outbound investors, such as superannuation funds, investing in foreign limited partnerships and other entities which are treated as transparent for both Australian and foreign income tax purposes, by ensuring that such foreign entities are excluded from the definition of deducting hybrid.

- Some relatively subtle changes in the Bill have been supplemented by additional guidance in its Explanatory Memorandum (**EM**) clarifying the circumstances in which income will be regarded for purposes of the hybrid mismatch measures as "subject to Australian income tax" or "subject to foreign income tax" due to operation of an Australian or foreign CFC regime. In broad terms, the income must be included in the assessable income of the relevant taxable shareholder under that CFC regime. This means that if the payment is offset by deductions at the CFC level, or if an attributable taxpayer's attribution interest is less than 100 per cent, only the amount included in the shareholder's assessable income under the CFC regime may be regarded as subject to income tax in the shareholder jurisdiction.

Targeted integrity rule (TIR)

The TIR focuses primarily on intra-group financing arrangements within multinational groups where funds are routed through interposed foreign entities resulting in an Australian tax deduction (*e.g.* for interest on a loan) and imposition of foreign income tax on the payment at a rate of 10% or less.

As a result of this integrity measure, there is a need to more broadly consider group payments, not just those directly made from Australia. In particular, if an Australian company pays interest to a foreign company, which is subject to tax at more than 10%, this is not of itself conclusive that the rule does not apply. It will be necessary to look beyond the immediate lender to understand how it is funded.

The TIR provisions in the Bill incorporate a number of modifications to those released as part of the March 2018 exposure draft legislation. Noteworthy modifications to the TIR provisions include:

- It is no longer a threshold requirement that the interposed foreign entity be tax resident in a different foreign country to the ultimate parent. This means that an even broader range of fact patterns may now be within scope of the TIR and, in turn, the new principal purpose test (see below) and the exceptions to the TIR will become even more important.

- The exception to the TIR for schemes not "designed to produce" an Australian deduction and imposition of foreign tax at a rate of 10% or less has been replaced by a "principal purpose" test. As Deloitte submitted in the consultation process, the "designed to produce" concept resembled concepts used in section 974-80(1)(d) of the *Income Tax Assessment Act 1997* and may have given rise to similar challenges in its practical application. The principal purpose test in the TIR is similar to those applicable under Australia's multinational anti-avoidance law (**MAAL**) and diverted profits tax (**DPT**) and, further, is now a threshold requirement for application of the TIR. The principal purpose test will be satisfied where it is reasonable to conclude that an entity that entered into or carried out all or part of the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of, enabling the Australian deduction and imposition of foreign income tax at a rate of 10% or less. In applying the principal purpose test, regard must be had to whether the interposed foreign entity engages in substantial commercial activities in carrying on a banking, financial or other similar business and (in the case of an interest payment) the interposed entity's source of funds.

- Previously, the TIR enquired whether the relevant payment is "*subject to foreign income tax … in the country of residence of the interposed foreign entity at a rate … that is 10% or less*" (or not subject to foreign income tax). As Deloitte submitted in the consultation process, this test may have been problematic in practice where a partnership or trust is the interposed foreign entity and the partners or beneficiaries are tax resident and subject to tax at more than 10% in a different jurisdiction. The provision arguably represented a departure from the general deduction / non-inclusion rule which does not require that the foreign tax be payable in a particular country. Under the revised test in the Bill, the TIR requires the relevant payment to be "*subject to foreign income tax in one or more foreign countries, and the highest rate … is 10% or less*" (or not subject to foreign income tax). The Bill also clarifies that the TIR will not apply where a payment is regarded as subject to Australian income tax.

- The exception to the TIR for certain payments included under Australian or foreign controlled foreign company (**CFC**) regimes has also been modified. The Bill provides that the payment must be "taken into account" under the Australian CFC regime and the CFC must generally be wholly owned directly (or potentially indirectly via certain foreign entities) by Australian tax residents, or that "similar" requirements are satisfied in relation to the operation of a foreign CFC regime. This appears to be in response to concerns about whether the operation of particular foreign CFC rules, such as the US "GILTI" measures, may activate the exception.

  The EM to the Bill indicates that a payment should be regarded as "taken into account" under the Australian CFC regime where it is an amount of notional assessable income or notional exempt income (potentially even if attributable income is nil) and, in the case of a foreign CFC regime, where the payment is included in the tax base of the CFC on a separate entity basis. In the case of a foreign CFC regime, the Bill also requires that the regime have "substantially the same effect" as the Australian CFC regime, which the EM indicates will not be the case where the amount included is reduced or offset by amounts of a kind not allowable under the Australian CFC regime, such as deductions, losses or other attributes pooled from other group entities.

- The types of back to back arrangements that must effectively be disregarded in applying the TIR, *i.e.* enabling the TIR to apply having regard to the ultimate payee, are now limited to those involving payments of interest, rather than derivative payments.

- The Bill provides for specific schemes or circumstances to be excepted from the TIR from time to time by way of legislative instrument.

Other changes

The Bill and EM include various other additions and modifications to the Exposure Draft versions, including:

- New provisions dealing with the interaction of the proposed hybrid mismatch measures with other areas of Australian tax law, including the thin capitalisation rules, capital gains tax provisions, trading stock provisions and core rules for assessing foreign residents.

  In relation to the thin capitalisation rules, the Bill clarifies that the hybrid mismatch rules and the thin capitalisation rules will effectively disregard each other's application. This means that debt deductions will not be treated as non-deductible under the hybrid mismatch rules merely because they are disallowed under the thin capitalisation rules and, conversely, that debt giving rise to deductions disallowed under the hybrid mismatch rules must be taken into account in determining debt balances for purposes of the thin capitalisation rules.

- A new safe harbour offers potential relief for Australian branches of foreign banks that might otherwise be impacted by the proposed measures in relation to deductions for notional interest and derivative payments under Part IIIB of the *Income Tax Assessment Act 1936* (Australian Branches of Foreign Banks). The safe harbour applies if the foreign bank "*adopts a recognised transfer pricing methodology in allocating expenditure and income between itself and all its branches*".

- In addition, under a measure potentially of broader relevance than merely addressing hybrid mismatches, the Bill extends the election to 'opt out' of Part IIIB to foreign banks resident in non-treaty countries.

Key takeaways

The proposed rules are complex and of broad scope, and generally do not include grandfathering relief or materiality exceptions. Taxpayers should review their group structures and cross border payments in preparation for the rules potentially applying as early as 1 January 2019. In addition to testing arrangements involving hybrid entities and hybrid instruments, various fact patterns that intuitively might not present as "hybrid" arrangements may also merit consideration, including branches, tax consolidation regimes, income deferrals, concessional tax rates and 'low tax' financing vehicles. In particular, given the broad scope of the proposed rules and having regard to the imported mismatch rule and the TIR (each of which may impact many normal cross border arrangements and require review of upstream and/or back to back arrangements) every taxpayer making cross border payments should consider the potential application of the rules to their circumstances.

The Australian Taxation Office has commenced releasing materials, such as the draft PCG, regarding certain aspects of the proposed rules. In time, this is expected to also include guidance in respect of structured arrangements and the imported mismatch rule.

Contacts

Manu Sriskantharajah
Partner

+ 61 3 9671 7310
msriskantharajah@deloitte.com.au

Claudio Cimetta
Partner

+ 61 3 9671 7601
ccimetta@deloitte.com.au

Vik Khanna
Partner

+ 61 3 9671 6666
vkhanna@deloitte.com.au

Mark Hadassin
Partner

+ 61 2 9322 5807
mhadassin@deloitte.com.au

Alistair McLean
Partner

+ 61 2 8260 4669
alastairmclean@deloitte.com.au

David Watkins
Partner

+ 61 2 9322 7251
dwatkins@deloitte.com.au

Jonathan Schneider
Partner

+ 61 8 9365 7315
joschneider@deloitte.com.au

Jacques Van Rhyn
Partner

+ 61 7 3308 7226
jvanrhyn@deloitte.com.au

Jonathan Hill
Australian desk, NY

+1 718 508 6805
jonhill@deloitte.com

Peter Radlovacki
Partner

+ 61 2 8260 4243
pradlovacki@deloitte.com.au