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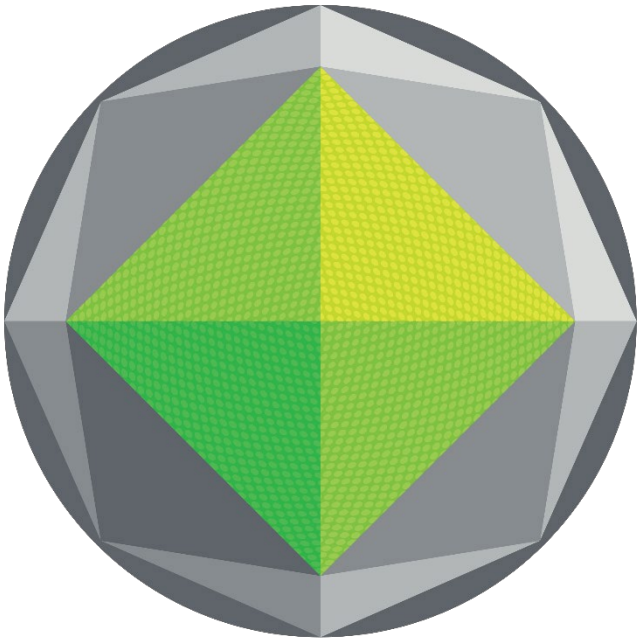
15 May 2020

Australia 2020/15



Tax Insights

Hybrid mismatch rules – Amendments introduced to Parliament

Snapshot

Amendments to Australia's hybrid mismatch rules that were foreshadowed in the 2019-2020 Budget were introduced to Parliament on 13 May 2020 in Treasury Laws Amendment (2020 Measures No. 2) Bill 2020. The amendments cover a range of technical matters affecting investors whose structures include transparent and hybrid entities and those that provide group finance via lowly taxed entities.

The Bill also includes **previously unannounced** changes that narrow the scope of the rules for certain branch structures, clarify the operation of the dual inclusion income rules and provide more flexibility to recognise the effects of similar laws in other countries, all of which are changes that are positive for taxpayers as they ease some of the compliance burden for multinational groups associated with the hybrid rules. These are welcome adjustments as we near lodgment of the first year of returns (for years ended 31 December 2019) that will be impacted by the hybrid measures.

In summary, the amendments:

- clarify the operation of the hybrid mismatch rules for trusts and partnerships;
- clarify the circumstances in which an entity is a deducting hybrid;
- clarify the operation of the dual inclusion income rule;
- clarify the operation of provisions that refer to equivalent foreign hybrid mismatch rules;

- clarify that, for the purpose of applying the hybrid mismatch rules, foreign income tax generally does not include foreign municipal or State taxes;
- clarify that the hybrid mismatch rules apply to MEC groups in the same way as they apply to consolidated groups;
- ensure that the hybrid mismatch integrity rule can apply appropriately to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules; and
- where distributions made on Additional Tier 1 capital instruments give rise to a foreign income tax deduction:
  - allow franking benefits on those distributions; and
  - include an amount equal to the amount of the deduction in the assessable income of the entity that makes the distribution.

Overview

The hybrid mismatch rules were introduced in 2018 and implement Australia's adoption of the OECD hybrid mismatch and branch mismatch rules to negate the impact of differences in treatment of financial instruments and entities between Australian and foreign counterparts.

The rules are wide in scope and apply to all types of payments made by Australian businesses to both related parties and third parties. Broadly the rules operate to deny deductions or include an amount in assessable income, according to a prescriptive set of rules that apply to payments that fall into one of one of the 7 defined hybrid mismatch arrangements:

- hybrid financial instruments
- hybrid payer
- reverse hybrid
- branch hybrid
- deducting hybrid
- imported mismatch
- targeted integrity rule

As part of the hybrid mismatch measures introduced in 2018 related amendments were also made to some of Australia's foreign source income exemptions and the franking rules as they relate to 'frankable/deductible' hybrid regulatory capital arrangements.
Some of the Bill amendments impact a number of the hybrid mismatch rules.
Parliament is scheduled to return for a two week sitting in June 2020, so the Bill may proceed through the Parliament next month.

Deducting hybrid rule

The Bill includes a new amendment since the Exposure Draft, narrowing the scope of the deducting hybrid rule to entities that are either:

- liable entities in one country but not the other;
- dual resident liable entities; or
- members of a consolidated group or MEC group.

The effect of the narrowed scope is that simple inbound and outbound branch structures, which would have previously been ordinarily treated as 'deducting hybrids' will no longer be captured by the hybrid rules. This will significantly decrease the compliance burden for such branches, including outward investing individuals and small business entities and trusts, who will no longer need to consider the complex double deductions and dual inclusion income rules or complete the related international dealings schedule disclosures. Paired with the amendments discussed below relating to dual inclusion income this signifies a welcome relaxation of the rules when it comes to outbound investment structures.
Inbound investors who carry on business through an Australian branch will also no longer need to be concerned with the burden of complying with the double deduction rule, unless the investor entity possess other hybrid features. For example, US 'checked open' entities remain a likely hybrid arrangement within scope of the rules.

Foreign hybrid mismatch rules

The meaning of 'foreign hybrid mismatch rules' is contained in section 995 and serves to ensure that only one country denies a particular hybrid mismatch, according to the OECD recommended primary/secondary framework. Uncertainty surrounding the meaning is referred to in the EM insofar as concerns were raised as to whether a foreign law was benchmarked against the whole of Division 832 or the particular type of hybrid mismatch.

The Bill amends the particular secondary response and offshore hybrid provisions to clarify that a foreign law need only correspond to the specific type of hybrid mismatch rule in order to discharge the need for the Australian hybrid mismatch rule to operate. These amendments pave the way for questions to be posed as to whether specific US laws including the US hybrid rule and the US dual consolidated loss rules sufficiently correspond to the particular Subdivisions of Division 832.

MEC groups

A minor amendment has been made to treat MEC groups in the same way as consolidated groups for the purposes of the hybrid mismatch rules. This will provide clarity to MEC groups whose positions may have been uncertain when applying the deducting hybrid mismatch rule. This change will apply retrospectively from income years commencing on or after 1 January 2019.

State taxes

Broadly, the hybrid mismatch rules operate where a payment gives rise to an Australian deduction which is not matched by inclusion in a foreign income tax base (deduction/non-inclusion outcome or DNI outcome), or a payment gives rise to an Australian deduction and also gives rise to a foreign income tax deduction (deduction/deduction mismatch or DD outcome). For these purposes inclusion or foreign income tax deduction, as relevant, is measured by testing whether foreign income tax is payable under a foreign law in respect of the payment, or an amount is deductible in working out a tax base under a foreign law dealing with foreign income tax, respectively.

As such, the imposition of taxes at a municipal or sub-national level give rise to a question as to whether there is inclusion for the purposes of measuring a DNI outcome, and whether there is a foreign income tax deduction for the purposes of measuring a DD outcome.

The Explanatory Memorandum cites these concerns and unreasonable compliance burdens that would impact affected taxpayers if sub-national taxes were included in the definition. Accordingly, the definition of foreign income tax, for the purposes of the hybrid mismatch rules only, will exclude municipal taxes and, in the case of a federal foreign country, state taxes. This change will apply retrospectively from income years commencing on or after 1 January 2019.

However, in a revision since the Exposure Draft was released, this change will not impact the foreign income tax considered for the purposes of the targeted integrity rule. The targeted integrity rule applies to deny deductions in respect of related party interest and derivative payments where a foreign conduit is taxed at a rate of 10% or less on the payment and the principal purpose of the financing scheme was to obtain this low tax outcome.

This is a welcome amendment since the Exposure Draft as it removes uncertainty for groups with higher than 10% effective tax rate related party financing that would have existed in relation to applying the principal purpose test.

Trusts and partnerships

Trusts and partnerships are commonly used as cross-border investment vehicles but their status as 'entities' for the purposes of Australia's tax laws poses some technical difficulties in applying concepts such as the 'liable entity' definition in the hybrid mismatch rules, which is meant to broadly align with the concept of a tax paying entity, or an entity that is generally subject to tax.

The amendments seek to clarify that trusts and partnerships, as opposed to the trustee or partners, are the relevant entities that need to be examined in terms of determining the tax implications of payments that could potentially give rise to hybrid mismatches. In doing so, the hybrid mismatch rules, and in particular the deducting hybrid mismatch rule, should not apply to a trust or partnership that is typically treated as a flow through entity for Australian tax purposes. The EM specifically notes Division 6 trusts and Division 276 AMITs are treated as flow through entities for tax purposes and distinguishes these from Division 295 superannuation funds and Division 6C public trading trusts. This change will apply retrospectively from income years commencing on or after 1 January 2019.

Targeted integrity rule

The targeted integrity rule applies to inbound groups with related party interest or derivative payments made by Australian businesses to an interposed entity that is subject to tax at a rate of 10% or less. However, the targeted integrity rule does not apply to a payment if one of the other hybrid rules has already applied to the same payment.

This circumstance could arise in the following scenarios:

- the hybrid financial instrument mismatch rule applies because a financial instrument is held by a low (but not zero) taxed entity and there is a timing deferral that triggers the hybrid requirement; or
- the deducting hybrid mismatch rules applies because a hybrid entity makes an interest payment that is also deductible in a foreign country and the foreign country denies the deduction, or, the neutralising amount is less than the double deduction due to an application of dual inclusion income.

The Bill amends both the ordering rule in the targeted integrity rule and the adjustment provisions in the hybrid financial instrument mismatch rule and the deducting hybrid mismatch rule to ensure that the targeted integrity rule can apply in a residual manner in these circumstances.

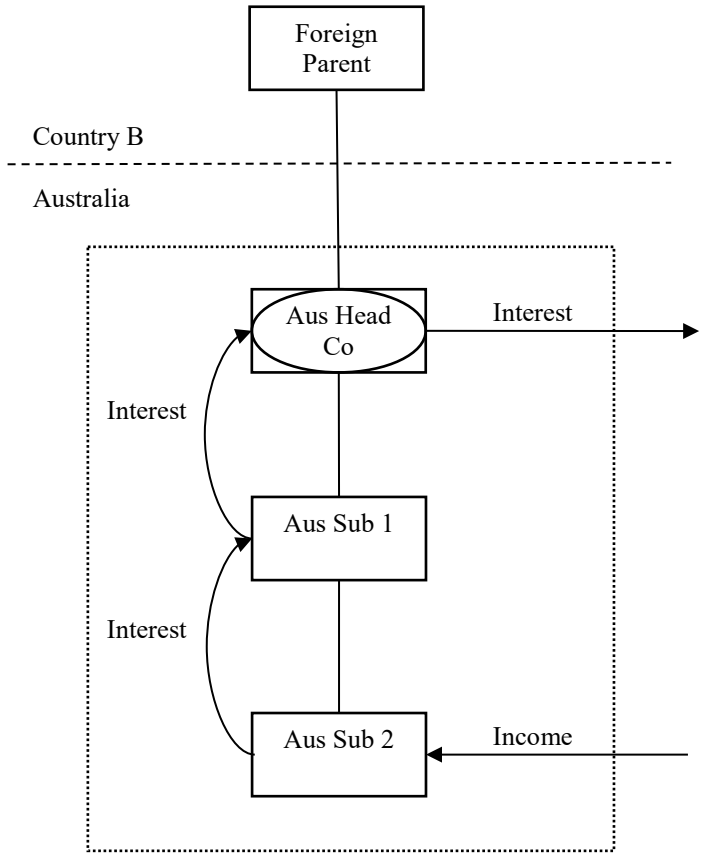
The greatest impact of these changes will be felt by inbound hybrid and branch entities such as subsidiaries of US multinational groups which are 'checked open' and taxable Australian branches (i.e. investor country does not apply a branch exemption). Under the current rules no further analysis is required for financing payments made by these entities if there is sufficient 'dual inclusion income'. Additional analysis of financing payments made by these entities will now be expected by the ATO and will be necessary particularly given the disclosure requirements in the current International Dealings Schedule.

These changes will take affect for income years beginning on or after 2 April 2019.

Dual inclusion income

A number of welcome changes to the dual inclusion income rules have been addressed in the Bill, beyond what was first foreshadowed in the Exposure Draft. These changes accommodate for situations involving intra-consolidated group payments as well as difficulties that arose as a result of applying the dual inclusion income rule to non-corporate entities in an outbound context and situations involving non-corporate head entities. Broadly, dual inclusion income is income which is taxed in more than one jurisdiction and can be applied in the context of hybrid entity mismatches to reduce the amount of the deductions denied by the rules.

The first amendment deals with situations where income is derived from a related entity, and because it is not always possible to recognise the particular item of income or profits as having been subject to tax in both countries the 'on-payments rule' extends the concept. The EM cites concerns that have been raised in relation to the interpretation of the on-payments rules in the context of payments made through multiple members of a dual inclusion income group. The amendment addresses this so as to include a clarification that the provision can be applied in an iterative fashion and includes a 'reasonable to conclude' basis for determining whether an amount of funding income or profits has been subject to tax.
An example of the on-payments rule operation is included in the EM example 1.2:



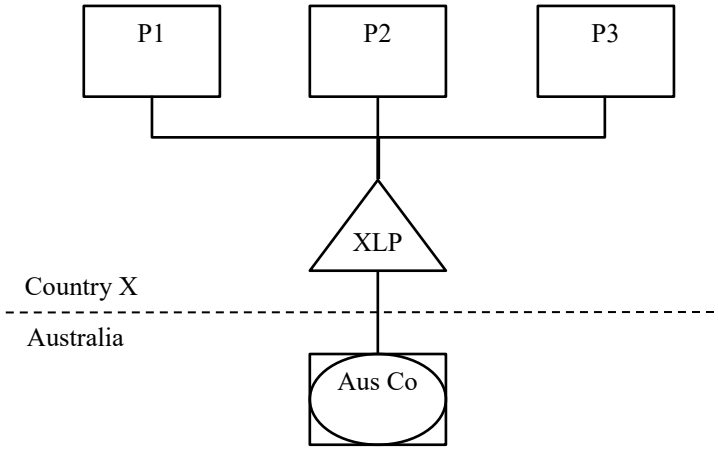
In this example the Aus Head Co is a hybrid entity that may be able to effectively trace the interest income it receives from Aus Sub 1 to the external income derived by the consolidated group for the purposes of determining it's dual inclusion income. Absent this rule, Aus Head Co's interest deductions could potentially be denied by the deducting hybrid mismatch rule.

It should be noted that the on-payment rule still requires an element of factual analysis to satisfy the 'reasonable to conclude' test and Australian businesses will need to assess all of its sources of funding in relying on the on-payment rule. This will also be particularly relevant for inbound service companies that are hybrid entities which are rewarded on a recharge basis. Businesses with relatively consistent intra-group payment flows should be able to develop a pragmatic approach and attention will now turn to whether the ATO can provide practical guidance on these matters.

The second amendment to dual inclusion income which is a feature of the Bill previously not included in the Exposure Draft relates to clarification of the foreign income tax offset (FITO) reduction which was introduced to address integrity concerns with outbound hybrid structures. However, subsection 832-680(2) is extremely impracticable for trusts and partnerships to comply with given the interaction with the FITO entitlements which sit with the ultimate beneficiaries and partners. Therefore, the rules will be amended so that only the reduction of dual inclusion income for FITO entitlements only applies to corporate tax entities. This will be a welcome change particularly for outbound trusts and funds and the superannuation industry.

The third amendment to dual inclusion income relates to dual inclusion income grouping which is relevant where reliance may be required for the above mentioned 'on-payments' rule. Previously, a dual inclusion income group could only be formed if there was only one liable entity in respect of the income or profits of the group members. As a result, investments held by a transparent holding vehicle with multiple investors typically would not be able to form a dual inclusion income group. The amendments resolve this anomaly and enable groups that are headed by a transparent vehicle to access the on-payments rule. The EM provides the following example:

Example 1.1:



P1, P2 and P3 are companies that are residents of Country X and that collectively have a wholly owned partnership interest in a limited partnership (XLP).
XLP, which is also formed in Country X, has a wholly owned Australian subsidiary (Aus Co) that is treated as a disregarded entity – that is, for Country X purposes, Aus Co is treated as part of XLP and not as a separate liable entity.

For Country X tax purposes, P1, P2 and P3 are each:

- liable entities in respect of their own income or profits and part of the income and profits of both XLP and Aus Co; and
- not liable entities in respect of each other's income or profits.

Aus Co derives income of $100 in an income year. This income is subject to Australian income tax in the hands of Aus Co. This same income will be subject to foreign income tax in Country X in the hands of P1, P2 and P3 based on their respective partnership interests in XLP.
For Country X tax purposes, P1, P2 and P3 are the liable entities in respect of each of Aus Co and XLP. Apart from P1, P2 and P3, there are no other liable entities in respect of Aus Co and XLP's income or profits. Therefore, Aus Co and XLP will be members of a dual inclusion income group in Country X.

P1, P2 and P3 will not be members of this dual inclusion income group in Country X as they are not liable entities in respect of each other's income or profits.
For the same reason, XLP will also not be in a dual inclusion income group in Country X with any of P1, P2 or P3.

Lastly, in a change which will be welcomed by outbound property trusts, the dual inclusion income rule will be amended so that deductions which offset foreign source income are not adversely impacted by the double deductions hybrid rule.
These changes will have retrospective effect for income years commencing on or after 1 January 2019.

Hybrid regulatory capital

Changes made to the franking rules in section 207-158 as part of the hybrid mismatch measures broadly operate to deny imputation benefits on distributions where all or part of the distribution gives rise to a foreign income tax deduction. These arrangements typically affect additional Tier 1 (AT1) capital issued by ADIs and insurance companies where the AT1 is attributable to a foreign branch.

The EM cites an issue with this rule applying to the whole of a distribution where a comparatively small amount of the distribution gives rise a foreign income tax deduction. To address this, the Bill provides an exception to the denial of imputation benefits in certain circumstances so that distributions may continue to be franked if the company forgoes its foreign income tax deduction. This exception will apply for ADIs and insurance companies and as a condition to qualify for the exception the company must notify the Commissioner of Taxation that it or any other entity will not claim the foreign income tax deduction.

Takeaways

These amendments will be welcomed as the clarifications remove certain entities from the scope of the hybrid mismatch rules where there was an imbalance between the compliance burden and the risk of hybrid entity exploitation and provide more flexibility for those in the rules to apply the dual inclusion income rules appropriately. However, those with inbound hybrid entity structures, such as US 'checked open' subsidiaries and groups with low tax related party financing structures should continue to be mindful of the application of the hybrid mismatch rules and should expect that the ATO focus to continue to be directed at these structures.

Of particular note:

- Inbound and outbound branches – changes are positive – unless the entity possess other hybrid features, is a dual resident or member of a tax consolidated group or a MEC group the 'deducting hybrid' will not apply
- Service entity subsidiaries deriving internal recharges – changes are positive – but dual inclusion income is still matter of practical compliance, which requires review and documentation
- Related party financing combined with inbound hybrid entities – changes are potentially negative with respect to related party financing expenses as targeted integrity rule now has residual application, which means more detailed review of arrangements
- Trust and partnership investment vehicles – changes are positive – clarifies that trusts should not ordinarily be treated as hybrid entities.

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