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2015/31 - Australia

Tax insights
BEPS: Neutralising Hybrid Mismatch Arrangements

Snapshot

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima on 8 October, the OECD Secretariat published thirteen papers and an Explanatory Statement outlining consensus Actions under the Base Erosion and Profit Shifting ('BEPS') Project. These papers include and consolidate the first seven reports presented to and welcomed by the G20 Leaders at the Brisbane Summit in 2014.

The output under each of the BEPS Actions is intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines.

As part of the 2015 output, the OECD has published a Final Report on Action 2 ('the Report') in relation to neutralising the effects of hybrid mismatch arrangements, which proposes domestic law amendments and treaty changes.

In Australia, following announcements made in the May 2015 Federal Budget, the Board of Taxation ('the Board') is currently consulting on the implementation of anti-hybrid rules in accordance with the OECD's recommendations under Action 2. The Board is required to report by March 2016 in time for the May 2016 Federal Budget.

The proposed rules are expected to impact the tax outcomes arising from a number of commonly used financing approaches in Australia. Taxpayers should consider the potential application of the rules to their financing structures and the associated tax, financial reporting, legal and treasury issues which may arise – including the potential need to refinance existing structures.

Australian perspective

In the May 2015 Federal Budget, the Government announced that the Board had been asked to consult on the implementation of anti-hybrid rules in accordance with the OECD's recommendations under Action 2.

On 14 July 2015, the Federal Treasurer released the terms of reference for this project. The terms of reference include a request that the Board report to the Government by March 2016 "to allow this issue to be considered as part of the 2016 [Federal] Budget". While there has been no public discussion on the timing of introduction of such rules, the Board's reporting deadline raises the possibility of 'legislation by press release' on these rules in Australia, with potential effect from May 2016.

In its March 2015 final report into the Debt and Equity rules of Division 974, the Board also identified related hybrid issues arising from the interaction of Subdivision 768-A and Australia's Controlled Foreign Corporation ('CFC') rules. It could be that action on these issues is also addressed as part of the broader report on the implementation of anti-hybrid rules.

Australia may be one of the 'first wave' of countries adopting anti-hybrid rules, based on its proactive stance on these matters. The timing of the adoption of such measures is an important factor to consider. In some cases, the order of application of anti-hybrid rules requires consideration of whether anti-hybrid rules have been adopted in a counterparty jurisdiction.

Taxpayers in Australia will need to continue monitoring the changing legislative framework of countries in which they do business, to accurately assess how Australia's rules will interact with those of foreign jurisdictions and the related impact on the tax outcomes arising under their financing arrangements.

Action 2 recommends the anti-hybrid rules apply in priority to domestic interest limitations such as those proposed by Action 4. In the case of Australia, it is expected such rules would apply in priority to the existing domestic thin capitalisation rules. As discussed in our **Tax Insight (13 October 2015)** on Action 4, it would appear that Australia intends to retain its existing thin capitalisation regime rather than adopt the OECD's recommendations under Action 4.

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OECD Proposals

The proposals contained within the (Final) Report are broadly in line with the Interim Report released in September 2014. The recommendations are designed to neutralise mismatches by targeting the following types of arrangement: Deduction/No Inclusion (D/NI) outcomes, Double Deduction (D/D) outcomes and Indirect Deduction/No inclusion (Indirect/NI) outcomes.

The Report includes 80 examples to supplement the recommendations in Part I and provide further guidance in respect of how the rules will operate in practice. Although the design principles state that the rules should be clear and transparent and minimise compliance costs, some of these examples demonstrate that the rules will necessarily be complex.

The Report notes that the hybrid mismatch rules would apply before any general or overall limitation on income or expenses including interest limitation rules which could be included in domestic rules as a result of Action 4.
Further work has been undertaken on asset transfer transactions (e.g. stock lending and repo), imported hybrid mismatches and the interaction with CFC regimes.

Recommendations

Specific hybrid mismatch rules are recommended to address each of these arrangements. The recommendations are in the form of 'linking' rules to be adopted within domestic legislation; a primary rule (denying a deduction) and a secondary rule, to apply in circumstances where the primary rule does not apply.

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommend hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments. Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime. Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque.	Deny payer deduction	-	Control group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to control group and structured arrangements
	Deductible payment made by a dual resident		Deny resident deduction	-	No limitation on response
Indirect D / NI	Imported mismatch arrangements		Deny payer deduction	-	Members of a control group and structured arrangements

Hybrid Financial Instrument Rule – Specific Points

Payee/Payer jurisdiction can be the same

Although D/NI outcomes most commonly arise where the payer and payee jurisdictions are different, the Report notes that this is not a requirement of the rules.

Reduced rate/partial exemption

The Report clarifies that a mismatch will not arise, simply because a country generally taxes income from all financial instruments at a lower rate than other types of income.

Where the income is partially exempt or only that type of income (for example, dividend income) is subject to tax at a reduced rate, proportionate adjustments should be made to neutralise the mismatch.

Payments

The financial instrument rule applies to 'substitute payments' and payments to the extent those payments give rise to a D/NI outcome. 'Payment' is defined in Recommendation 12 as 'any transfer of value and includes an amount that is capable of being paid' such as a future or contingent obligation to make a payment. Payments that are only deemed to be made for tax purposes are specifically excluded as they do not involve the creation of any new economic rights between the parties.

The examples provide guidance on items which are intended to be included and excluded under this definition. In particular, the forgiveness of a debt is a transfer of value between two entities, however, it is not a 'payment'. In addition, foreign exchange differences are not included as the gains and losses are attributable to the way jurisdictions measure the value of money rather than the value of the payment itself.

CFC Income

The recommendations are not intended to give rise to economic double taxation. In certain cases, a payment under a hybrid financial instrument that gives rise to a D/NI outcome may be included in the income of a parent under a CFC regime.

To avoid economic double taxation, consideration should be given as to whether a payment has already been included under a CFC regime. A taxpayer seeking to rely on the inclusion should only be able to do so in circumstances where it can satisfy the tax administration the payment has been fully included under the laws of the relevant jurisdiction and is subject to tax at the full rate.

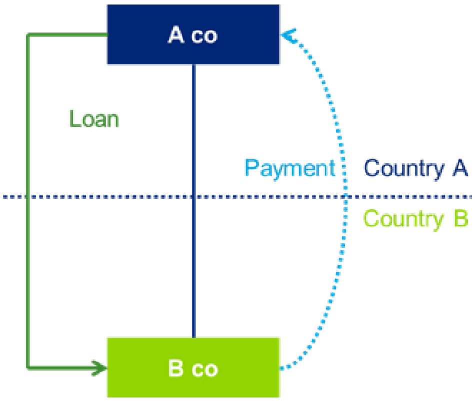
The rules that determine income included under a CFC regime can make the determination of whether an amount has been included in ordinary income difficult and fact intensive. Accordingly, the Report recommends that materiality thresholds must be carefully considered before treating a CFC inclusion as reducing the amount of adjustment required under the financial instrument rule.

Timing differences

The financial instrument rule does not generally apply to timing differences. The Report recommends that a payment should not be treated as giving rise to a D/NI outcome provided the tax administration can be satisfied that the payment under the instrument is expected to be included in income within a reasonable period of time. A payment can be expected to be included in ordinary income where there was a reasonable expectation at the time the instrument was issued that the payment would be made and that such payment would be included in ordinary income by the payee at the time it was paid. The determination of whether this payment will be made within a reasonable period of time should be based on the time period that might be expected to be agreed between unrelated parties acting at arm's length.

The Report recommends a safe harbour – a payment should not be treated as giving rise to a mismatch if it will be required to be included in the payee's ordinary income in an accounting period that commences within 12 months of the end of the payer's accounting period.

Interest Payment to an Exempt Person



- Both jurisdictions treat the loan as a debt instrument. A Co is a sovereign wealth fund that is exempt from tax on all income and is therefore not taxable on the interest income.
- The payment of interest under the loan gives rise to a mismatch in tax outcomes. This D/NI outcome will not, however, be treated as a hybrid mismatch unless it can be attributed to the terms of the instrument.
- If the mismatch in tax outcomes would not have arisen had the interest been paid to a taxpayer of ordinary status, then the mismatch will be solely attributable to A Co's status as a tax exempt entity, and cannot be attributable to the terms of the instrument itself.
- Consequently, the mismatch in tax outcomes will not be caught by the hybrid financial instrument rule.

If the terms of the instrument would bring about a mismatch in tax outcomes (i.e. the payment would not have been included even if it had been made to an ordinary taxpayer) then the mismatch will be treated as a hybrid mismatch and subject to a potential adjustment under the hybrid financial instrument rule.

There are other examples considering payments to persons established in a no-tax jurisdiction or which operate full territorial tax regimes. The rules will not apply in these circumstances.

Imported mismatch rule

Although the recommendations are intended to be implemented through domestic law in all participating countries, they are designed to work effectively even if not all countries make such changes. It is possible for groups to have a hybrid mismatch arrangement between two countries, which do not introduce the rules, and then transfer the benefit to a third country using an arrangement that does not give rise to a hybrid mismatch. The imported mismatch rules, if adopted in the third country would deny a deduction in that country.

The proposed rules involve an unavoidable degree of co-ordination and complexity, the guidance sets out three tracing and priority rules to be used to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement. This area is one of the most complex in the Report and there are a number of examples included in Annex B.

Treaty provision on transparent entities

The 1999 OECD report, 'The Application of the OECD Model Tax Convention to Partnerships' ('Partnership report') contains an analysis of the application of treaty provisions to partnerships, including where there is a mismatch in the tax treatment of the partnership, however, it did not expressly address the application of tax treaties to entities other than partnerships. In order to address this, it was decided to include in the OECD Model Tax Convention a provision and Commentary which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership report. This will ensure that the benefits of tax treaties are granted in appropriate cases and that these benefits are not granted where neither Contracting State treats the income of an entity as the income of one of its residents under its domestic law.

Transitional rules and losses under the imported mismatch rule

There are no transitional rules contained within the Paper and it is generally expected that the rules should apply to payments made after the rules are brought into effect.

In respect of the imported mismatch rules it is noted that in order to account for timing differences and to prevent groups manipulating that timing in order to take effect of the imported mismatch rule, a hybrid deduction should be taken to include any net loss that has been carried forward to a subsequent accounting period, to the extent the loss results from a hybrid deduction. In order to reduce complexity it is recommended that any carry forward losses from periods ending on or before 31 December 2016 should be excluded from the operation of this rule.

Implications for business

It is relatively common for groups to include hybrid entities especially if they have US head companies or have US investment and have ‘check the box’ entities. Developments in this area are therefore likely to be of wide interest.

The examples that are included in the Report are helpful for tax authorities and taxpayers, but demonstrate the potential complexity of the rules. In addition, the main recommendations are domestic measures and therefore the groups to be affected will depend on if, and when countries choose to implement the new rules.

At this stage it is difficult for groups to assess whether the primary, secondary or imported rules could apply and they may need to model the possible effect under various scenarios.

For some groups this may be only the first stage in the process as they may also need to consider the other BEPS final reports, in particular BEPS Action 4 – Interest Deductions and other Financial Payments.

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