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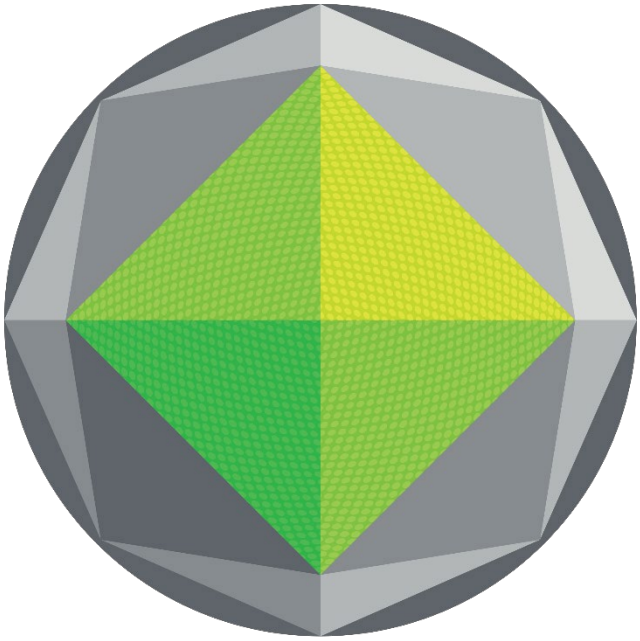


Tax Insights

Hybrid mismatch rules – Exposure Draft amendments released for comment

Snapshot

Amendments to Australia's hybrid mismatch rules that were foreshadowed in the 2019-2020 Budget were released as Exposure Draft legislation on 13 December 2019. The amendments cover a range of technical amendments mainly affecting inbound investors whose structures include transparent and hybrid entities and those that provide group finance via lowly taxed entities.

In summary, the amendments:

- clarify that the rules apply to multiple entry consolidated groups (MEC groups) in the same way as consolidated groups;
- clarify that the definition of 'foreign income tax' does not include foreign municipal or State taxes;
- clarify how the rules apply in the context of trusts and partnerships;
- remove the ordering rule for the targeted integrity rule in cases where there has been a double deduction mismatch and limits the adjustment provisions in certain circumstances;
- clarify the dual inclusion income on-payment rule so that it can be applied to consecutive payments in a group; and
- allow franking benefits on distributions made on Additional Tier 1 capital instruments in some circumstances.

In detail

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 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 these Exposure Draft amendments impact a number of the hybrid mismatch rules.

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 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 Exposure Draft explanatory materials cite 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 on or after 1 January 2019.

This change will also 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. Exclusion of state taxes

for the purpose of this rule will mean that more related party financing arrangements will meet the threshold conditions for the application of the rule, i.e. 10% or less foreign income tax. This will place a higher compliance burden on taxpayers having to satisfy themselves as to the principal purpose test. The explanatory materials provide some recognition of this (see paragraph 1.24), however given the principal purpose test is reliant on groups' particular facts and circumstances it is difficult to distil clear guidance as to the level of risk. Affected groups should closely review their structures and assemble evidence to support related party financing deductions for the income years ending 31 December 2019 onwards.

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 Exposure Draft 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 explanatory materials specifically note 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. It refers to amendments that will be made to Division 6C to ensure such trusts are within the scope of the hybrid mismatch rules, however these are not included in the Exposure Draft at this stage. This change will apply retrospectively from income years 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 Exposure Draft 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.

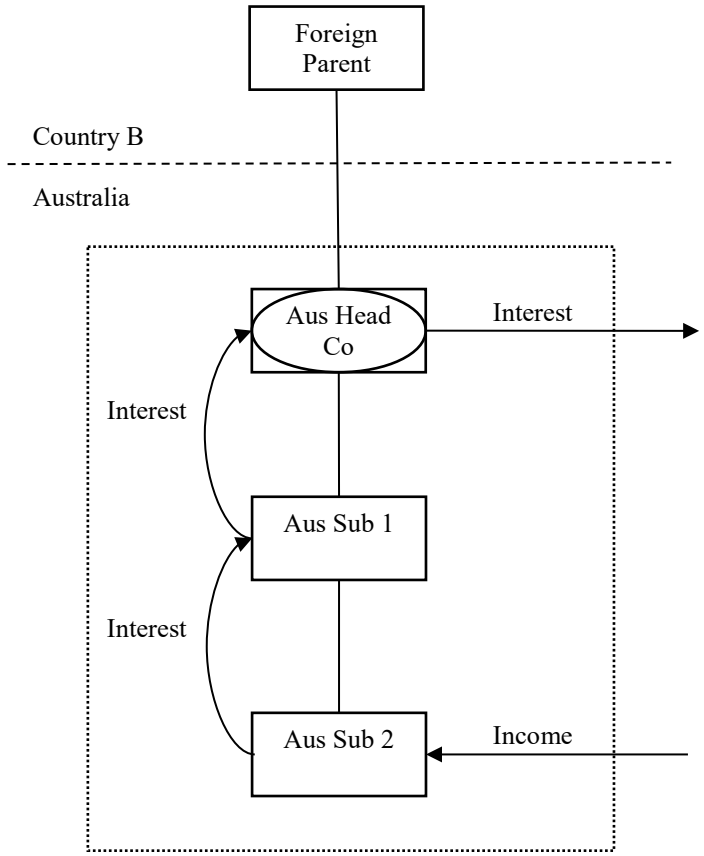
These changes will take affect for income years beginning on or after 2 April 2019.

Dual inclusion income

Welcome changes to the dual inclusion income rule have been addressed in the Exposure Draft to accommodate for situations involving intra-consolidated group payments. 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.

However, in situations where income is derived from a related entity, it is not always possible to recognise the particular item of income or profits as having been subject to tax in both countries and the 'on-payments rule' extends the concept accordingly. The Exposure Draft explanatory materials cite 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 proposed to address this is to include a clarification that the provision can be applied in an iterative fashion and include 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 explanatory materials:



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.

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 Exposure Draft explanatory materials cite 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 Exposure Draft legislation 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

The hybrid mismatch rules have a broad application and can apply in a number of unexpected circumstances. These Exposure Draft amendments, particularly those in relation to the exclusion of state taxes and the ordering rule for the targeted integrity rule, should be closely examined to determine if your business is affected.

The Exposure Draft contains a mix of positive and negative impacts for Australian businesses but those most likely to be affected include US inbound multinational enterprises (which have 'checked open' Australian subsidiaries) and groups with related party finance, in particular:

- Service entities subsidiaries deriving internal recharges – changes generally positive – but dual inclusion income is still matter of practical compliance, which requires review and documentation
- Financing from low taxed entities and branches – changes potentially negative – exclusion of state taxes means arrangements with effective tax rates >10% are within scope, which means more detailed review of arrangements
- Inbound branches and hybrid entities – changes 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 generally positive – clarifies that trusts should not ordinarily be treated as hybrid entities, but disclosures nevertheless required which require review and documentation.

With the ongoing focus by the ATO on compliance activity in relation to related party finance and its overall Justified Trust strategy, the chances of a review of potential hybrid structures within the next year are highly likely, if not already flagged. Furthermore, the level of tax return disclosures required from FY2019 means that it is important for all Australian businesses to fully understand the impact of these rules and have positions properly documented. If you would like advice in this regard, please contact our subject matter specialists.

Consultation on the Exposure Draft legislation is open until 24 January 2020.

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