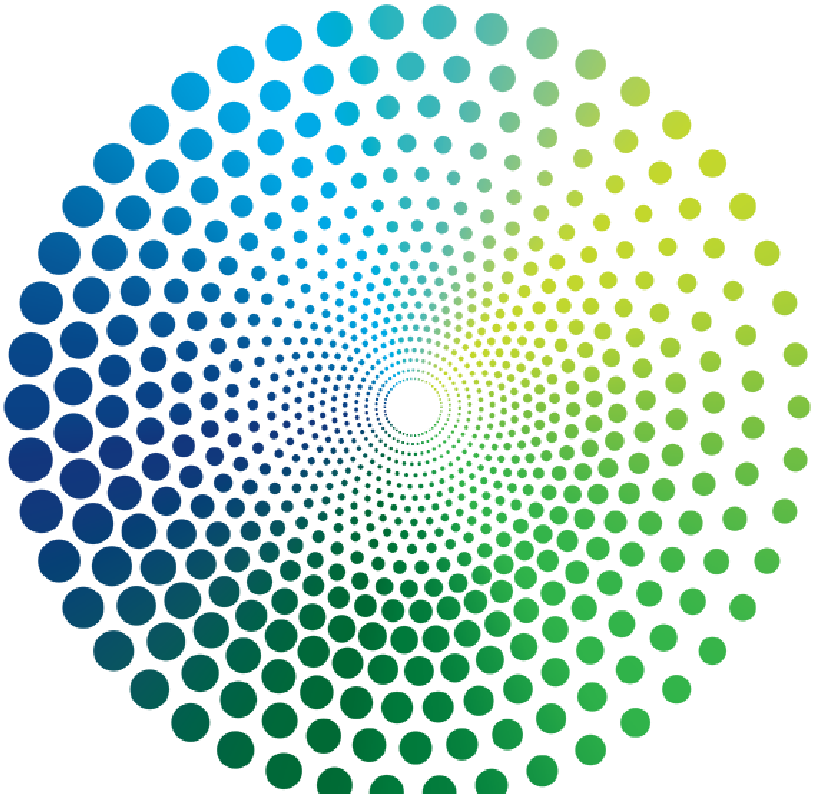
Deloitte.

21 April 2021
Australia 2021/7



Tax Insights

Imported hybrid mismatches – ATO risk assessment framework

Snapshot

Since their introduction in 2018, the hybrid mismatch rules (and in particular the imported hybrid mismatch rules) have presented Australian taxpayers with the new challenge to understand not only the Australian tax implications of their cross-border arrangements but also the foreign tax implications. For years commencing on or after **1 January 2020** this has become even more complex, with the onset of the **imported mismatch rule** for non-structured arrangements requiring Australian taxpayers to understand if their deductible payments fund a hybrid mismatch anywhere else in their global group[1].

---

[1] The imported hybrid mismatch rule applies to importing payments made under structured arrangements that are covered by table item 1 of subsection 832–615(2) of the Income Tax Assessment Act 1997 (ITAA 1997) for income years that commenced on or after 1 January 2019. For importing payments made directly or indirectly to an offshore deducting entity that are covered by table items 2 or 3 of subsection 832–615(2), the imported hybrid mismatch rule applies for income years that commenced on or after 1 January 2020.

On 21 April 2021, the ATO released Draft Practical Compliance Guideline (PCG) 2021/D3 (the Draft PCG) which sets out the Commissioner's **compliance approach** and **risk assessment framework** in connection with the **imported hybrid mismatch rules**, including the Commissioner's approach to reviewing whether a taxpayer has undertaken **reasonable enquiries** in relation to the rules for **non-structured arrangements**.

The Draft PCG sets a high bar for compliance with these rules. The Draft PCG helps taxpayers to understand the expectations of the ATO in terms of evidence and information that should be maintained to support the deductibility of related party payments, and provides guidance on how to practically go about complying with the imported mismatch rule. However, for many taxpayers that are part of a large multinational group, this will do little to relieve the burden of the significant information gathering exercise required by these complex rules.

Key takeaways

- Cross-border payments which are otherwise deductible in Australia and which are made to, broadly, a member of an accounting consolidated group or an entity with 50% or more common ownership (referred to in this publication as related party payments) must be examined from the perspective of the imported mismatch rule and supporting information obtained prior to the lodgement of the relevant tax return. An Australian tax deduction should not be claimed unless the taxpayer has sufficient evidence to support a conclusion that the imported mismatch rule does **not** apply.
- The ATO takes the view that for a **structured arrangement**, the taxpayer has all relevant information necessary, or will be able to obtain that relevant information from the other parties to that structured arrangement.
- The draft PCG is principally concerned with the taxpayer's obligations to take **reasonable care** in connection in ascertaining relevant facts so as to apply the law to a **non-structured arrangement**.
- For **non-structured arrangements**, reasonable care to comply with the rule will be considered to have been taken if:
    - A taxpayer follows the ATO's "recommended approach" of either:
        - Following a '**top-down**' review approach that starts with identification of offshore hybrid mismatches and filters that information down to deductible related party payments made by the Australian taxpayers; or
        - Following a '**bottom-up**' tracing approach that repeats until all relevant related party payments have been verified; and
    - It is not the case that:
        - There is information known, or that should have been known, by the taxpayer or their agent, and the failure to consider that information leads to a tax shortfall; or
        - A member of the group has deliberately withheld information; or
        - A member of the group has deliberately provided false or misleading information.
- Taxpayers and their agents will generally not be able to demonstrate reasonable care if a related party deduction is claimed and 'they have not made enquiries or have not received adequate and complete responses from responsible qualified individuals', and it is subsequently found that the imported mismatch rule applied. Given the self-assessment nature of the hybrid rules, this places the compliance burden squarely on the taxpayer.

- The focus on reasonable care is in the context of Division 284 of the Taxation Administration Act[2]. Amongst other penalties, Division 284 includes penalties for failure to take reasonable care to comply with a taxation law.
- When the hybrid measures were introduced, it was noted that "It is likely that, where possible, many taxpayers will restructure out of hybrid arrangements that would otherwise be subject to the OECD hybrid mismatch rules (including arrangements subject to the integrity rule) and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules"[3]. The ATO notes in the Draft PCG that "Taxpayers, and their Division 832 control groups, may look to mitigate the cost of compliance by endeavouring to eliminate hybrid mismatch arrangements, including offshore hybrid arrangements, to which Division 832 could apply"[4].
- Where an offshore hybrid arrangements remain in place, the Draft PCG states the ATO view that "For a taxpayer to be satisfied that they are entitled to deductions for cross-border payments that they make to members of its Division 832 control group, the taxpayer must determine whether any of their cross-border payments result in an offshore hybrid mismatch being directly or indirectly imported into Australia … A taxpayer should **not** claim a deduction for a payment unless they are able to **obtain sufficient information** to support a conclusion that the deduction in respect of the payment is **not** disallowed under Subdivision 832–H. Where the taxpayer later obtains further information that confirms entitlement to a deduction for that payment, they can lodge an amendment request to claim the deduction"[5].

Recap: what is the imported mismatch rule?

The hybrid mismatch rules are the implementation of the OECD BEPS Action 2 Report and are essentially provisions that deny deductions or include assessable income to 'neutralise' the effect of a one-sided tax deduction or a double deduction, commonly referred to as 'double dips' and technically called 'deduction / non-inclusion' mismatches (**DNI**) or 'deduction / deduction' mismatches (**DD**). The hybrid rules and the imported mismatch rule do not contain a purpose element, and hence are much broader than the general anti-avoidance laws. There is also no scope limitation or de minimis rule and the types of deductible payments which can be impacted include a broad range of expenses such as interest, royalties, leases, management fees and purchase of goods or services.

The imported mismatch rule is an integrity measure contained in the hybrid mismatch rules. It applies where an Australian taxpayer makes an otherwise deductible payment to another entity which directly or indirectly funds an offshore DNI or DD mismatch.

---

[2] Administrative penalties for statements, unarguable positions and schemes.

[3] Paragraph 1.20, Explanatory Memorandum, Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018.

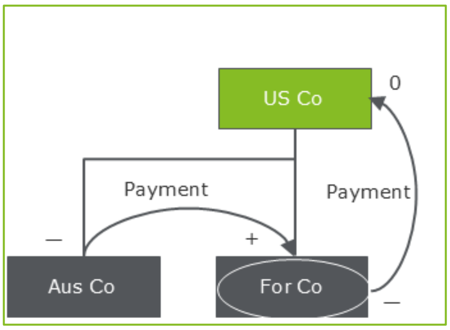
[4] Paragraph 9 of the Draft PCG.

[5] Paragraphs 13 and 16 of the Draft PCG.

For there to be a denial of a deduction to an Australian taxpayer for a **non-structured arrangement,** broadly the following two components needs to exist in an income year:

1. There is an **offshore hybrid mismatch** involving two foreign related parties, such as a hybrid financial instrument or a hybrid entity structure that gives rise to a DNI or DD mismatch; and
2. The Australian taxpayer must have made an **importing payment** that directly funds the offshore deducting entity, or indirectly funds the offshore deducting entity via a series of payments through interposed entities that are assessable/ deductible through the chain of entities.

Simple example



- Aus Co makes an otherwise deductible payment to For Co
- For Co is subject to income tax in its local jurisdiction on the payment from Aus Co
- For Co makes a payment to US Co, which is deductible to For Co in its local jurisdiction
- US Co is not subject to income tax in the US on the payment from For Co, on the basis that For Co has effectively been treated as a branch of US Co under the US 'check the box' rules, such that the transaction between US Co and For Co is disregarded for US tax purposes.

The imported mismatch rule also applies to both 'structured arrangements' and non-structured arrangements, with the latter applying (broadly) to transactions within a 'controlled group'.
The application of the rules only began for **non-structured arrangements** from income years beginning on or after 1 January 2020. This aligns with the inception date of the application of hybrid mismatch rules in the European Union under Anti-Tax Avoidance Directive II. This is relevant because payments made to entities that are taxable in a country that has implemented their own 'foreign hybrid mismatch rules' should not give rise to an imported mismatch. Whilst there is little guidance on when foreign laws will qualify as 'foreign hybrid mismatch rules', EU countries, the UK and New Zealand are expected to comply.

For income years beginning between 1 January 2019 and 31 December 2019, multinational enterprises should focus on any payments that are made under a scheme where a DNI or DD mismatch was a 'design feature' of the scheme[6]. There is limited guidance on what this means although the concept is extremely broad. The structured arrangement concept remains important post 1 January 2020 as such arrangements are denied in priority to non-structured arrangements.

[6] The Commissioner's view of this is contained in PCG 2019/6.

ATO’s recommended approach

The ATO’s recommended approach for **non-structured arrangements** is set out in paragraphs 23 to 33 of the Draft PCG.

Top-down approach

1. Obtain the core information from the Global Head of Tax
2. Filter information by Australian tax manager
3. Quantify the offshore hybrid mismatch
4. Identify any interposing payments and quantify the imported mismatch.

Bottom-up approach

1. Identify all potential importing payments
2. Identify mismatch outcomes for the direct tested entities
3. Identify potential interposed payments made by direct tested entities
4. Identify and follow payments.

Further detailed steps are set out in the Appendix to the Draft PCG describing the expected information gathering that will be undertaken to meet the above. For example, the Appendix includes the identification of all in-scope offshore payments, and then for each such payment requires a description of:

- 11 characteristics of the payment associated with a DNI transaction; or
- 7 characteristics of the payment associated with a DD transaction.

The ATO expects that enquiries will be made of “suitably qualified or responsible individuals”: this will include “the person primarily responsible for the Group’s tax obligations, such as the Head of Tax for the Group, and may also include other appropriate qualified responsible individuals or suitably qualified representatives”.

ATO’s risk assessment framework

A risk assessment framework sets out the Commissioner’s view on the level of compliance risk, which will be disclosable in the Reportable Tax Positions Schedule.

Risk Zone	Risk Level	Example
White	Self-assessment of risk rating not necessary	• Engaged with the ATO and demonstrated not within scope of the imported mismatch rules; or • Imported hybrid risk already dealt with in a pre-lodgement compliance review and assessed as "low risk" or "high assurance"; • In the white zone per the above in any of the last two income years, and confirmation that the circumstances have not materially changed.
Green	Low risk	Not within Red zone 2 and either: • Sufficient evidence obtained using the ATO recommended approach to demonstrate no imported mismatch risk exists; or • Insufficient evidence obtained but no deductions claimed for relevant related party payments.
Blue	Low-moderate risk	Otherwise deductible related party payments <$2 million.

Yellow	Moderate risk	• Sufficient evidence obtained using the ATO recommended approach to verify:
		  • That at least 90% of otherwise deductible related party payments do not pose an imported mismatch risk; and
		  • For the remaining 10% the maximum possible imported mismatch risk is less than 2% of assessable income; and
		  • Not within Red zone 2.

Amber	Moderate-high risk	• Evidence obtained using the ATO recommended approach that identifies an offshore hybrid mismatch; and • A position is taken that there is no importing payment*; • Not within Red zone 2.
Red 1		A **structured arrangement** has been identified in relation to an offshore hybrid mismatch and you do not have evidence to demonstrate that the mismatch has been neutralised by the Australian imported mismatch rule or corresponding rules in other jurisdictions.
Red 2	High risk	A position has been taken in relation to a **structured arrangement** and that the payment was not made directly or indirectly through interposed entities.
Red 3		Made an otherwise deductible related party payment which does not fit within any other risk zone, including where you have obtained insufficient information to demonstrate compliance.

* The ATO notes that it is concerned about positions being taken that are inconsistent with section 832-625(3)(a), which deals with indirect importations being taken to exist if there are a series of payments that exist between interposed entities. Based on the PCG example, the ATO appears to be concerned with a view that purports to negate this condition on the basis that payments are made at different times within an income year.

The ATO states that "if you are outside the low risk zone, we do not presume that your related-party arrangements fail to comply with the Australian tax law. However, where a taxpayer is outside a low risk zone, we consider that there is a greater risk that your related-party arrangements will give rise to inappropriate tax outcomes. In these cases, we are more likely to conduct some form of engagement and assurance activity to further test the taxation outcomes of your arrangements".

Submissions

Submissions on the Draft PCG are due by **21 May 2021**.

What should you do?

The imported mismatch rule and the Draft PCG applies to Australian multinational groups as well as Australian subsidiaries of foreign multinationals, but the latter group have a far greater challenge, given the information that they will need to analyse the imported mismatch rule risk will reside outside of Australia.

Notwithstanding that the PCG is still in draft form, the immediate steps for all multinationals should be:

- Consider the Draft PCG in the context of your tax governance framework and determine how you will respond against the risk assessment framework.
- Identify the responsible representatives within the global group that will qualify for the ATO's recommended approach. The Draft PCG indicates that this must include the person primarily responsible for the Group's tax obligations from a global perspective, such as a Head of Tax, and may also include other treasury and finance representatives and regional tax managers.
- Consider your systems' capability to apply one of the recommended approaches and prepare relevant information request lists. The Appendix to the Draft PCG contains a 'general guide' which is a non-exhaustive list of information that the ATO expects would be obtained in order to demonstrate compliance, which is very detailed.
- Perform a risk assessment and obtain relevant supporting information prior to lodging your return, noting that if no information or insufficient information is obtained and you have related party payments in excess of $2 million, the high risk zone will automatically apply.

Given the first set of company returns affected by these rules will be due in July 2021, it is important that Australian taxpayers consider this as a matter of priority, particularly as the ATO guidance is that "a taxpayer should not claim a deduction for a payment unless they are able to obtain sufficient information to support a conclusion that the deduction in respect of the payment is not disallowed".

Each multinational group will have their own unique needs in terms of accessing information about the global structure and the key to success in applying the ATO's Draft PCG will be in starting early and committing the resources to consider the issues thoroughly.

21 April 2021

Contacts

Amelia Teng
Partner
+ 61 3 8486 1118
amteng@deloitte.com.au

Mark Hadassin
Partner
+ 61 2 9322 5807
mhadassin@deloitte.com.au

Vik Khanna
Partner
+ 61 3 9671 6666
vkhanna@deloitte.com.au

Claudio Cimetta
Partner
+ 61 3 9671 7601
ccimetta@deloitte.com.au

Manu Sriskantharajah
Partner
+ 61 3 9671 7310
msriskantharajah@deloitte.com.au

David Watkins
Partner
+ 61 2 9322 7251
dwatkins@deloitte.com.au

Jonathan Hill
Partner
+ 61 3 9671 6984
johill@deloitte.com.au