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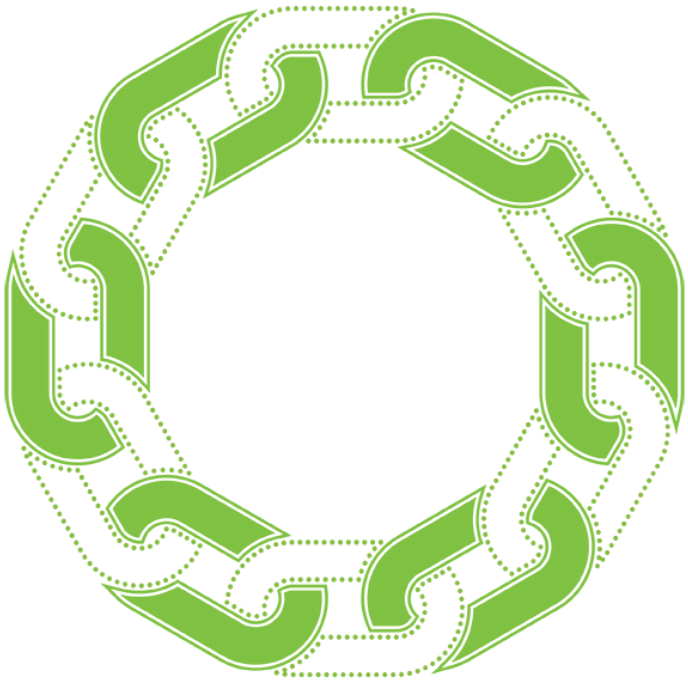

Tax Insights

ATO releases hybrid mismatch guidance dealing with US GILTI rules

Snapshot

The ATO has released further draft guidance in relation to the Hybrid mismatch rules, as the first year of the application of the hybrid mismatch rules draws to a close. TD 2019/D12 outlines the Commissioner's interpretative view that section 951A of the US Internal Revenue Code (the **GILTI rule**) does not correspond to the operative provisions of Australia's controlled foreign company (**CFC**) rules (sections 456 or 457 of the Income Tax Assessment Act 1936 (ITAA36)) for the purposes of determining whether an amount is considered subject to foreign income tax by the hybrid mismatch rules.

The consequence of this view is that deductible payments made by Australian businesses to subsidiaries of US parented groups may potentially suffer economic double taxation through the parallel operation of the Australian hybrid mismatch rules and the US GILTI rule. In particular, this issue may arise for payments made to the US parent's non-US subsidiaries, which are CFCs for US tax purposes.

The Commissioner's view in the draft TD that the GILTI rule does not correspond to sections 456 or 457 is primarily based on differences between the mechanics of the GILTI rule, which apply a worldwide aggregated basis, and the methodology of Australia's operative CFC rules, which apply on an entity by entity basis, as well as perceived differences in the policy rationale of the GILTI rule as a global minimum tax rule compared to Australia's general CFC anti-deferral regime.

Context of the guidance

The draft determination is the fifth piece of guidance released by the ATO in relation to the Hybrid mismatch rules since the rules were enacted in late 2018. It addresses the last topic which has been consistently listed under the ATO's advice under development program and will provide clarity on this area of uncertainty for many taxpayers coming to grips with how these rules impact their Australian businesses as part of a global group structure.

The hybrid mismatch rules (Division 832 of the Income Tax Assessment Act 1997) implement Australia's adoption of the OECD Action 2 recommendations to eliminate the effect of mismatches in the tax treatment of instruments and entities. The hybrid mismatch rules are complex but broadly apply where a payment is made under a hybrid arrangement and gives rise to a 'deduction/non-inclusion' outcome or a 'deduction/deduction' outcome.

For payments made by Australian businesses, the key concept used to determine whether there is a 'deduction/non-inclusion' is whether the amount is 'subject to foreign income tax', which broadly tests whether the amount is included in the tax base of a foreign country. The definition contains a specific extension where an amount is received by another entity (i.e. a CFC) and it is included in a foreign tax base under a provision that corresponds to section 456 or 457 of the ITAA36. This subsection represents the optional OECD Action 2 recommendation that countries take account of CFC inclusion. The subject to foreign income tax definition is also relevant to determining amounts of 'dual inclusion income' which can shelter certain hybrid mismatch payments.

The hybrid mismatch rules therefore demand that Australian businesses understand how cross border payments are treated in the hands of foreign counterparties to their arrangements. The ATO has recognised the difficulty in determining this by listing foreign law interactions under its advice under development program since the introduction of the hybrid mismatch rules. The GILTI rule is a foreign law that businesses and commentators have long queried, in particular as it was not a foreign law that existed when the OECD Action 2 report was released and a relatively new concept when Division 832 was introduced.

Interpretational guidance

This issue has been addressed by a tax determination which is a ruling provided by the Commissioner in relation to his interpretation on how a provision applies. It explains the Commissioner's view on whether the GILTI rule 'corresponds to' section 456 or 457, not whether there is an amount of inclusion from a policy or practical perspective.

The draft determination interprets the meaning of 'corresponds to' as requiring things to be similar, analogous or equivalent in function. It takes guidance from the Explanatory Memorandum (EM) to the hybrid mismatch rules and obiter in *Chevron* to form the view that rules must be consistent on an overall level and that similarities should be recognisable in their 'effect' or 'gist'.

It contains a brief outline of the Commissioner's understanding of the US GILTI rule and identifies the following key aspects:

- CFC-level items that that are taken into account by the GILTI rule include tested income, tested loss and qualifying business asset investment (**QBAI**);
- Net CFC tested income, determined on an aggregate basis;
- Net deemed intangible income return; and
- The legislative history and broader GILTI regime, including sections 250 and 960(d) of the IRC which enable US shareholders to offset foreign tax credits and a specific deduction for amounts included under the GILTI rule.

The US GILTI rule is described as a global minimum tax regime for which there is no equivalent in Australia. This description is anchored in the legislative history as understood by the Commissioner that the GILTI rule was introduced to protect the US tax base against erosion through the concentration of a multinational businesses high value functions, assets and risks in low taxed jurisdictions. The QBAI reduction to the amount included under the GILTI rule is determined to be a key feature of the rule which signifies that it is a global minimum tax rule.

In contrast, sections 456 and 457 of the Australian legislation are described as the operative provisions of a general CFC anti-deferral regime, the policy intent of which is to assess Australian attributable taxpayers on an accruals basis in relation to particular passive and tainted income.

The draft determination explains that the mechanical function of the GILTI rule to apply on a global aggregate CFC basis is reflective of the 'effect' or 'gist' of the rule being a global minimum tax, which is sufficiently dissimilar to an anti-deferral regime that operates on a CFC by CFC basis.

Interestingly this interpretation is released at a time when there is significant discussion at an international level of how to approach the tax challenges arising from the digitalisation of the economy and in particular the OECD's Global Anti-Base Erosion (**GloBE**) proposal under Pillar Two, which borrows heavily from the GILTI rule concept. As Australia's position in relation to Pillar Two develops, the interaction of such rules with existing provisions including the hybrid mismatch rules should be considered closely.

Practical impact

The draft determination contains two examples which demonstrate the relevance of the interpretation:

1. A deduction/non-inclusion mismatch (D/NI) in a reverse hybrid context where an Australian business makes a deductible payment to a foreign limited partnership which is transparent in its formation country but treated as a US CFC – the effect of the Commissioner's view is that the payment would prima facie give rise to a D/NI. A reverse hybrid mismatch deduction is a permanent denial, with no offset for dual inclusion income. It applies to all forms of deductible payments (i.e. interest, royalties, COGS etc). The analysis would also apply in an indirect context in applying the imported mismatch rule where the Australian business makes a payment which indirectly funds a payment to a reverse hybrid.
2. Inclusion for the purposes of dual inclusion income – amounts that are included under the GILTI rule will not qualify as dual inclusion income and will therefore be ineligible to shelter hybrid mismatch payments identified under the hybrid payer or deducting hybrid rules.

A similar question is also relevant in the context of the targeted integrity rule (**TIR**), Australia's anti-conduit entity financing rule which applies to foreign controlled businesses' related party interest and derivative payments. Furthermore, the TIR broadly contains a specific exception for CFC inclusion by 100% attributable taxpayers under Part X of the ITAA 97 (Australia's CFC rules), and the exception also applies for foreign laws which have substantially the same effect although the TIR exception provision is drafted differently to section 832-130(5). The EM to the hybrid mismatch rules indicates that a rule that displays features like the GILTI rule would not qualify for the TIR exception and this draft determination, whilst not directly on point, appears to strengthen that view.

This draft determination highlights to importance of understanding foreign tax law interactions. Australian businesses should review their global structures to assess the impact of the hybrid mismatch rules generally whilst US inbounds, should have regard to the impacts of this draft determination. The ATO view is clear that Australian businesses should carefully consider the application of the hybrid mismatch rules to all their arrangements and not assume that potential mismatches will be remedied by foreign tax laws.

Submissions in relation to the draft determination are due 17 January 2020.

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