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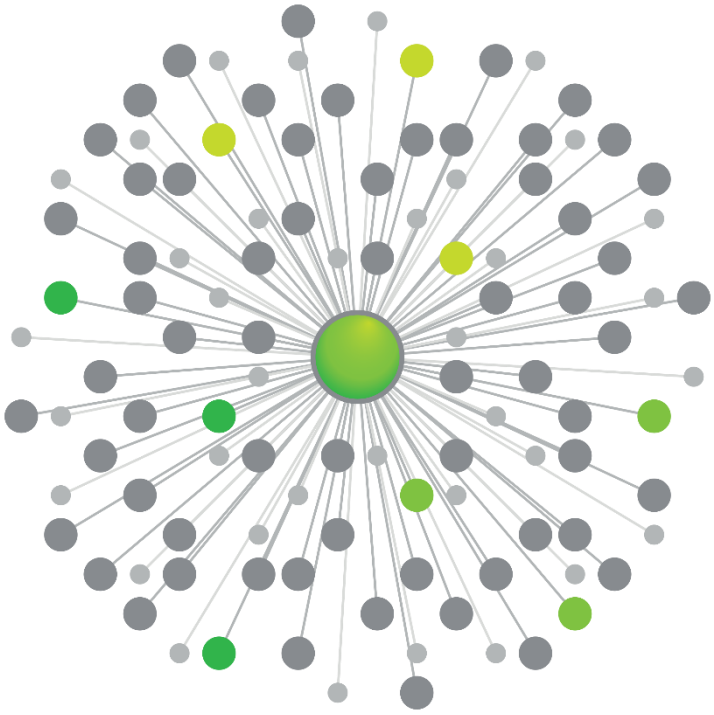


Tax Insights

Australian hybrid mismatch rules and other new international tax measures

Is your Australian business prepared?

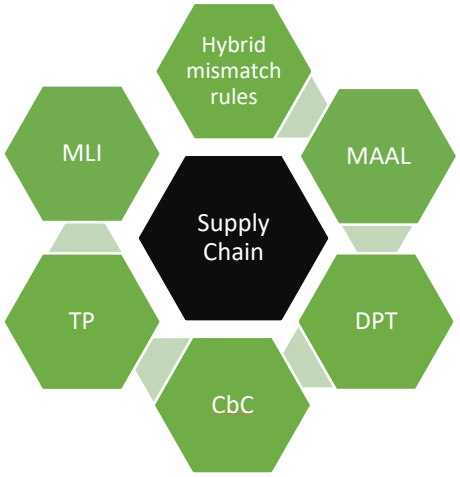
Overview

As we fast approach a new decade, Australian businesses are dealing with a raft of new international tax rules introduced since the onset of the OECD BEPS Action Plan:

- Hybrid mismatch rules
- Tightening of the thin cap safe harbour and shift in practice towards the arm's length debt test (**ALDT**)
- Multinational Anti-Avoidance Law (**MAAL**)
- Diverted Profits Tax (**DPT**)
- Country-by-Country reporting (**CbC**) and new transfer pricing guidelines; and
- Multilateral Instrument (**MLI**).

These new rules intersect with the core business considerations surrounding the capital structure and supply chain.

The introduction of these new measures has been paired with an increased scale and renewed approach to compliance engagement by the ATO with its "Justified Trust" strategy, which investigates tax risks flagged to the market (amongst other matters).



With the continuation of the Top 1000 tax performance program under the Tax Avoidance Taskforce funded to 2022-23 and an expansion of the Justified Trust program to private groups, these new international tax rules are having a significant impact on the tax function of Australian businesses. Furthermore, the heightened level of tax return disclosures and degree of supporting documentation required from FY2019 means that your Australian business must understand the effect of these new rules.

Practical impacts of some of the rules

Hybrid mismatch rules

The Hybrid mismatch rules apply from 1 January 2019 and have a wide scope that can apply to all Australian controlled businesses, including Australian branches, partnerships and trusts, and all Australian outbound investments including equity investments and branches. The rules operate to deny deductions or include assessable income in a bid to combat erosion of the global tax base that can arise because countries apply different tax treatment to financial instruments or to particular entities.

Broadly, the Hybrid mismatch rules combat arrangements where a payment gives rise to a:

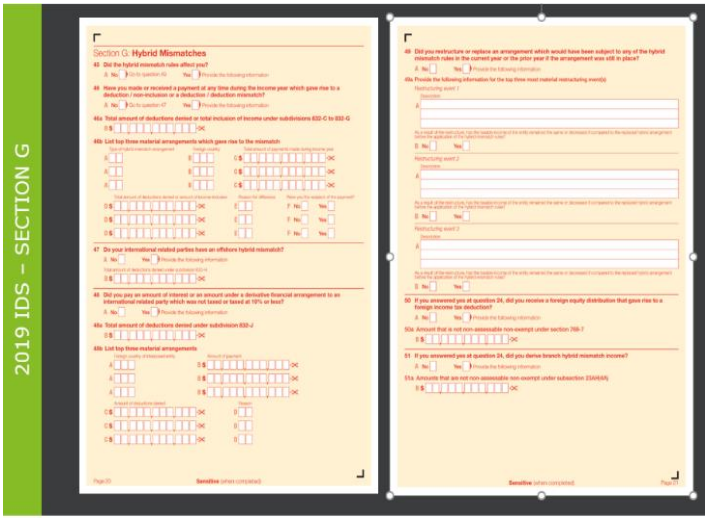
- Deduction/non-inclusion (**D/NI**) outcome – broadly, a deductible payment is not subject to income tax in the recipient's country (or ultimate recipient's country); or
- Deduction/Deduction (**D/D**) outcome – broadly, a deduction is allowed in more than one country for the same expense.

The rules are complex and require detailed factual analysis to determine which payments may be affected, and how much of a payment may be affected. It is necessary for Australian businesses to have an understanding of the global group structure of which they are a part of, no matter how small the relative Australian operations. This is particularly important for businesses that have related party cross-border dealings that can give rise to "imported mismatch" considerations.

The imported mismatch rule aims to align Australia with other countries around the world that have adopted hybrid rules, but it operates on the presumption that multinational groups have access to accurate and holistic data regarding the tax treatment of all their intra-group transactions and that such information is readily available to local businesses. The challenge for Australian businesses in 2020 is in being able to evidence that a robust process has been undertaken to support positions on the application of the imported mismatch rule. Notably, there is no "de minimis" threshold and so taxpayers must consider the rules irrespective of their global or Australian size.

Another rule which is likely to have significant impact on foreign controlled Australian entities is the targeted integrity rule (TIR), which is focused on conduit entity group financing vehicles. The TIR is an Australian specific rule that was introduced to prevent the circumvention of the core hybrid mismatch rules by routing finance into Australia via low or no tax rate jurisdictions. It applies to interest and derivative payments made directly or indirectly to related parties where the payment is taxed at 10% or less. Current Government proposals to amend the hybrid rules to exclude state-based taxes could also broaden impact of the application of the TIR.

From years ending 31 December 2019 onwards, the application of the imported mismatch rule and the TIR are only one of the detailed disclosures that is required in the International Dealings Schedule (**IDS**) – Section G. This new IDS section requires consideration of both the substance of the rules and quantification of amounts that are taken into account in determining their operative effect.



For example, inward investors into Australia via a transparent vehicle will find that they must disclose amount of gross 'double deductions' as well as gross 'dual inclusion income', even where there is no amount of deduction denied by the hybrid mismatch rules.

Other practical impacts that should be considered in relation to hybrids include:

- Cash tax impact of deductions being denied or additional assessable income
- Accounting impact
- Tax sharing and tax funding arrangements if group members are 'sharing' dual inclusion income or subject to a denied deduction
- Interaction of the Australian hybrid mismatch rules with other countries' rules. This could differ greatly depending what countries Australia is contracting with. The ATO is considering how to provide guidance in relation to foreign law interactions, in particular with respect to US tax rules
- Consideration of adjustment provisions to assess whether denials are permanent or only a timing impact
- Impact on the overall thin capitalisation position where debt deductions are denied as hybrid mismatch payments or TIR payments
- Potential withholding tax on hybrid mismatch payments.

Thin capitalisation

It has now been over 5 years since the thin capitalisation rules were tightened with the safe harbour debt test reducing from 75% to 60%. This change in law resulted in an increased number of taxpayers seeking to rely on the arm's length debt test (ALDT) in order to preserve their interest deductions. The recent change to remove 'thin cap only' revaluations is expected to see a further increase in the application of the ALDT.

The ATO has recently revisited its guidance on the ALDT and has published a new draft ruling and PCG in 2019. These products are expected to be finalised in the new year and represent a departure from the earlier guidance in terms of the increased expectation placed upon taxpayers to provide robust analysis and evidence to support their application of the test. The thin capitalisation position, including detailed amounts and specific questions in relation to revalued intangible assets must be disclosed in the IDS.

MAAL

The MAAL applies to significant global entities (**SGEs**) and was introduced with effect from 1 January 2016. It is an anti-avoidance measure introduced as an amendment to Part IVA and targets arrangements that avoid permanent establishment (**PE**) status in Australia.

Broadly, the MAAL applies is under a scheme (or in connection with a scheme):

- A foreign entity supplies goods or services to an Australian customer
- An Australian entity that is an associate of or commercially dependent on the foreign entity undertakes activities directly in connection with the supply
- Some or all of the income derived by the foreign entity is not attributable to an Australian PE; and
- The principal purpose, or one of the principal purposes of the scheme, is to obtain an Australian tax benefit or to obtain both an Australian and foreign tax benefit.

The ATO released a Law Companion Guideline LCG 2015/2 in respect of the MAAL, which contains some examples of high-risk scenarios and low risk scenario including framing questions for how business could undertake an assessment of their risk of the MAAL applying. However, for the range of businesses in the middle ground there remains an exposure that it would be prudent to understand, particularly given the increased penalties for SGEs in respect of tax avoidance or profit shifting schemes.

Much of the relevant information relevant to identifying a potential MAAL risk will be included in the local file and must also be disclosed in the IDS.

Diverted Profits Tax

The DPT applies to SGEs and was introduced with effect from 1 July 2017. It is an anti-avoidance measure introduced as an amendment to Part IVA and targets arrangements that divert profits from Australia to offshore through arrangements that do not reflect the economic substance of activities undertaken in Australia.

Broadly, the DPT applies if under the scheme, or in connection with the scheme:

- A taxpayer has obtained an Australian tax benefit in connection with the scheme in an income year
- A foreign entity associate entered into or carried out the scheme
- The principal purpose, or one of the principal purposes, of the scheme, is to obtain an Australian tax benefit or to obtain both an Australian and foreign tax benefit
- None of the following exceptions apply:
    - The $25m income test
    - The sufficient foreign tax test
    - The sufficient economic substance test.

The impact of a DPT assessment are significant, with a penalty tax rate of 40% with payment required 21 days after the DPT assessment and a restricted dispute process.

The ATO released a Law Companion Ruling LCR 2018/6 and a Practical Compliance Guideline PCG 2018/5 setting out the ATO's risk assessment approach and provides framing questions and scenarios to guide Australian businesses. Given the 40% penalty tax rate and increased penalties for SGEs in respect of tax avoidance or profit shifting schemes, Australian businesses should have a clear understanding of the DPT risk over any of their related party cross-border payments.

What should Australian businesses be doing now?

Australian businesses can be prepared to support their tax return positions and disclosures and respond to ATO engagement by:

- Connecting with internal stakeholders globally to understand what arrangements in the global group structure could affect the Australian business
- Undertake a prudential review of all cross-border payments and entity structures that exhibit hybrid features, MAAL features or DPT features
- Prepare documentation outlining the process undertaken for identifying potential D/NI, D/D, imported mismatches or TIR payments
- Review and document any positions taken in relation to dual inclusion income or the TIR exceptions (e.g. ultimate parent entity or CFC inclusion)
- Review and document any positions taken in relation to a purpose for any of the TIR, MAAL or DPT, or the MLI, and
- Review ALDT positions and model the impact of recent changes to 'thin cap only' revaluations.

See also:

More headaches for SGEs - August 2018

Diverted profits tax: where are we now? - 27 September 2018

ATO publishes draft practical guidance on arm's length debt test - 28 August 2019

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