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# Tax Insights

## Australian anti-hybrid rules

On 24 November 2017, the Australian Government released exposure draft legislation (the **ED**) addressing hybrid mismatch arrangements. The ED seeks to implement the recommendations of the 2015 OECD report *Neutralising the Effects of Hybrid Mismatch Arrangements*.

### Key points

- As expected, the proposed rules are largely in line with the OECD recommendations, including some Australian-specific adoptions such as denial of imputation benefits in certain circumstances.
- The proposed rules are heavily prescriptive and apply to "control groups" or "structured arrangements".
- Although the rules do not yet cover branch mismatches, the Government has indicated these will be included in due course.
- In a step that goes beyond the OECD recommendations, the Government has also indicated it will legislate a targeted integrity rule addressing situations where multinational groups investing into Australia seek to "circumvent the hybrid mismatch rules".

- The rules do not contain any de minimis or materiality exemptions and will potentially apply to all taxpayers and transactions, subject to a carve-out for arrangements with a term of three years or less.
- The proposed commencement date (including for the branch mismatch and targeted integrity rules) is 6 months after Royal Assent. There will be no 'grandfathering' relief for existing arrangements.
- Deloitte will be engaged in the consultation process with submissions due by 22 December 2017.

## Action

Given the broad scope of the rules, particularly having regard to the imported mismatch rules, every taxpayer making cross-border payments should consider the impact of the proposed rules to their circumstances, including the potential need to refinance or restructure existing arrangements.

## Overview

The ED follows announcements in the 2016-17 and 2017-18 Budgets to the effect that the Government would implement the OECD hybrid mismatch rules developed by Action Item 2 of the OECD BEPS Action Plan, taking into account recommendations by the Board of Taxation. The proposed rules in the ED are aimed at eliminating double non-taxation benefits from hybrid mismatch arrangements arising in the context of differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions.

In broad terms, a hybrid mismatch will arise under the proposed rules if a payment gives rise to:

- a "deduction/non-inclusion" mismatch (e.g., a deduction for a payment is allowed in the payer's jurisdiction but is not included in assessable income in the recipient's jurisdiction); or
- a "double deduction" mismatch (e.g., a tax deduction is available for the same payment in two jurisdictions).

Importantly, the rules only apply where "deduction/non-inclusion" or "double-deduction" outcomes are attributable to the hybridity in the arrangement. Note that the proposed targeted integrity rule is likely to go beyond this fundamental approach (see below).

A mismatch which is covered by the proposed rules will be "neutralised" either by disallowance of a deduction or inclusion of an amount in assessable income. The ED applies to:

- a **hybrid financial instrument mismatch**: e.g., an offshore holder enjoys a participation exemption in respect of redeemable preference shares treated as debt interests for Australian income tax purposes and giving rise to deductions in Australia;
- a **hybrid payer mismatch**: e.g., an Australian company makes a deductible payment to its foreign owner in circumstances where the Australian company is treated as tax transparent in the owner's jurisdiction - such that the payment is non-taxable in that jurisdiction;

- a **reverse hybrid mismatch**: e.g., an Australian company makes a deductible payment to an offshore entity that is disregarded as an entity in the country of formation, but is treated as a separate entity from its owner in the owner's jurisdiction - such that the payment is disregarded/non-taxable in both the jurisdiction where the entity is formed and the jurisdiction of its owner;
- a **deducting hybrid mismatch**: e.g., a foreign entity makes a payment that is deductible in Australia and its place of formation; or
- an **imported hybrid mismatch**: e.g., an Australian company makes a deductible payment to an offshore entity where, although that entity is subject to tax on that payment in its own jurisdiction, a hybrid mismatch arises offshore which effectively shelters the payment from foreign tax.

## Sub-division 768-A to be amended

Australia's non-portfolio dividend exemption in Sub-division 768-A of the *Income Tax Assessment Act 1997* (Cth) will be modified to prevent it applying to foreign equity distributions where the foreign company payer is entitled to a foreign income tax deduction in respect of the distribution.

## ATO Guidance

The ATO has also updated its website to note that the Board of Taxation recommended that the ATO provide guidance on:

- Structured arrangements;
- The imported mismatch rule; and
- The application of Part IVA to restructures to avoid the application of the hybrid mismatch rules.

The ATO has indicated that it is addressing these by developing guidance covering new concepts under the law, and a Practical compliance guideline to address practical implications of the law and which will outline its administrative approach.

## Some observations

Although the rules implementing the above are complex, in broad terms they may be summarised as applying to payments under schemes involving hybridity of financial instruments or entities, and occurring in the context of related party and/or structured arrangements. Notably, the rules could potentially apply to all kinds of payments (including royalties, rent, and service payments).

The above concepts, as set out in detail in the ED, generally follow the OECD recommendations and involve the introduction into the *Income Tax Assessment Act 1997* (Cth) of a new Division 832 (Hybrid Mismatch Rules), thereby adding many new and untested concepts to Australian tax law. Unfortunately, the ED Explanatory Memorandum still leaves some questions unanswered which will make it difficult to apply these new concepts.

The ED materials do not include details of any consequential amendments to other areas of the law and accordingly the precise interaction between the proposed rules and other areas of tax law (e.g., thin capitalisation rules and CFC rules) is yet to be clarified.

The ED includes some "Australianisation" of the OECD recommendations, including:

- The proposed rules adopt the Board of Taxation's recommendation to exclude financial instruments or arrangements with a term of three years or less. This is a departure from the OECD recommendation on this point, which was to exclude financial instruments where a payment under the instrument if the tax administration could be satisfied the payment is expected to be included in income within "a reasonable period of time". The OECD report did not define "reasonable period" but recommended a safe harbour of twelve months. The adoption of the three year period in the ED reflects Board of Taxation comments that a twelve month safe harbour is too short and that "a three year safe harbour period strikes the right balance between ensuring long term deferral arrangements are no longer possible, and reducing compliance costs and uncertainty for taxpayers".
- The "single entity" rule in Australia's tax consolidation provisions is disregarded for purposes of identifying whether an entity makes a payment to another entity, or for determining the amount of income or profits of an entity.
- Australian imputation benefits will be denied on franked distributions made by an Australian corporate tax entity where the entity is entitled to a foreign income tax deduction in respect of all or part of the distribution.
- Transitional rules apply to Additional Tier 1 capital instruments issued by authorised deposit taking institutions before 9 May 2017. Under these rules, the amendments denying imputation benefits would not apply in relation to distributions on the relevant instrument made before the first available call date of the instrument that occurs on or after 9 May 2017.

## More to come

The Government has indicated that it will consult with stakeholders to develop branch mismatch rules and a targeted integrity rule:

- **Branch mismatches**: The 2017 OECD Report *Neutralising the Effects of Branch Mismatch Arrangements* recommended that countries address double non-taxation outcomes arising due to differences in the tax treatment of dealings within the same legal entity (e.g., dealings between a head office and a foreign branch). The Government has indicated that it will implement the recommendations of this 2017 OECD Report to bring the treatment of these arrangements in line with hybrid mismatch arrangements.
- **Targeted integrity rule**: The Government has also indicated that it will introduce an integrity rule targeted at multinational groups investing into Australia that seek to "circumvent the hybrid mismatch rules using investment structures and arrangements that may not fall within the scope of the OECD's hybrid mismatch rules. An example could be a foreign headquartered group investing into Australia using financing arrangements through interposed entities in zero tax countries that reduce Australian profits without those profits being subject to foreign tax". This targeted integrity rule goes beyond the scope of the OECD's recommendations and the Government has not provided any further guidance on its scope at this stage.

## Next steps

Following consultation, it is expected that the measures will be introduced into Parliament for enactment as law. At the earliest, this could occur in the first half of 2018, but may be delayed by the consultation on the branch mismatch and targeted integrity rules.

As per previous announcements, the proposed rules will commence 6 months after the Bill introducing the hybrid mismatch rules receives Royal Assent. The materials accompanying the ED suggest that this commencement date will also apply to the branch mismatch and targeted integrity rules. Accordingly, should the Bill receive Royal Assent prior to 30 June 2018 then (as currently drafted) the proposed rules would come into effect on some date prior to 31 December 2018, which may not coincide with the start or middle of a tax year. Payments made on or after the commencement date would in theory need to be tested under the new rules, without any grandfathering relief for existing arrangements.

The proposed rules are expected to impact the tax outcomes arising from many arrangements currently in place. Taxpayers should consider the potential application of the rules to their funding and operational structures and the associated tax, financial reporting, legal and treasury issues which may arise – including the potential need to refinance or restructure existing arrangements. Although the proposed commencement date should afford taxpayers an opportunity to consider unwinding existing arrangements, taxpayers will also need to consider implications of the yet to be formulated targeted integrity rule and any hybrid mismatch rules in other jurisdictions (e.g. comprehensive rules currently in the UK and proposed in New Zealand and the EU and specific hybrid mismatch rules in Japan, Netherlands, France and Germany). Australian taxpayers with US connections will also need to consider the proposed US tax reforms when considering any new arrangements.

Deloitte will be involved in the consultation process in respect of the ED (and the anticipated additional exposure drafts detailing the proposed branch mismatch and targeted integrity rules). Submissions in respect of the ED are due by Friday, 22 December 2017.

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