ATO guidance on low tax lender rule

5 April 2019

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In brief

On 5 April 2019, the Australian Taxation Office (ATO) issued a draft Law Companion Ruling (LCR 2019/D1) regarding particular aspects of Australia's low tax lender rule.

This 'integrity rule' was introduced with Australia's hybrid mismatch rules which have generally applied since 1 January 2019. This low tax lender rule is a key departure from the recommendations of the Organisation for Economic Cooperation and Development (OECD) in relation to hybrid mismatch arrangements and is designed to prevent multinational groups from using interposed conduit type entities that effectively pay no (or 'low') tax to invest in Australia, as an alternative to investing into Australia using hybrid entities or instruments.

The draft LCR provides welcome clarity in relation to a number of technical issues. However, many uncertainties remain and the practical application of the low tax lender rule will continue to present challenges for taxpayers. Notably the draft LCR does not address how this rule interacts with certain foreign tax regimes or ownership structures connected to foreign state-owned enterprises.

In detail

The low tax lender rule

The hybrid mismatch rules are very complex to navigate and in broad terms, operate to neutralise a hybrid mismatch by either denying a deduction or including an amount in assessable income (see our TaxTalk Alert of 28 May 2018 for a summary of the rules).

The low tax lender rule overrides the recommended OECD hybrid mismatch rules and has the potential to effectively impose additional Australian tax on interest and derivative payments to foreign interposed zero or low rate (FIZLR) related parties, irrespective of whether the arrangement involves a hybrid element.

This rule operates to deny Australian income tax deductions for payments where all of the following conditions are satisfied:

- an Australian entity makes a deductible payment under a scheme to a foreign entity (the interposed foreign entity) either directly, or indirectly through one or more interposed Australian trusts or partnerships;
- the Australian entity, the interposed foreign entity and another foreign entity (**the ultimate parent entity**, not controlled by any other entity) are in the same control group;
- the payment is of an amount of interest, or an amount in the nature of interest, or an amount under a derivative financial arrangement;
- the payment is not subject to Australian income tax;
- the payment is not subject to foreign income tax, or is subject to foreign income tax in one or more foreign countries, and the highest rate at which **the payment is subject to foreign income tax is 10 per cent or less**; and

- it is 'reasonable to conclude' (having regard to particular stipulated matters, see below) that participants who entered into or carried out the scheme 'did so for a principal purpose, or for more than one **principal purpose** that includes a purpose of: (i) enabling a deduction to be obtained in respect of the payment; and (ii) enabling foreign income tax to be imposed on the payment at a rate of 10 per cent or less, or enabling the foreign income tax not to be imposed on the payment'. In determining 'principal purpose', it is necessary to have regard to the following three matters:

    - the facts and circumstances that exist in relation to the scheme;
    - if the payment is an amount of interest, the source of the funds used by the foreign interposed entity to provide the Australian entity with the loan or other debt interest in respect of which the payment of interest is made (for example, equity funding of the foreign interposed entity might be indicative of a requisite purpose); and
    - whether the interposed foreign entity engages in substantial commercial activities in carrying on a banking, financial or other similar business (for example, conducting a function of providing finance to group members and a loan to the Australian entity consistent with normal business practice might suggest a requisite purpose does not exist).

Deductions will not be denied if it is 'reasonable to conclude' any of the following conditions are satisfied:

- the payment is taken into account under the Australian controlled foreign company (CFC) rules or the law of a foreign country that has 'substantially the same effect' as the Australian CFC rules; or
- assuming that the payment had been made directly to the ultimate parent entity, the payment would be: (i) subject to foreign income tax at a rate that is the same as, or less than, the foreign country rate or not be subject to foreign income tax; and (ii) the payment would not give rise to a hybrid mismatch.

The low tax lender rule also includes a conduit type rule which is applied on a look through basis to payments 'made under an arrangement involving **back-to-back loans** or an arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans' where certain other conditions are satisfied. In these circumstances, for the purposes of identifying a FIZLR entity, the Australian entity will be treated as having made the payment directly to the foreign entity that is the ultimate recipient in the back-to-back arrangement.

What does the draft LCR tell us?

A Law Companion Ruling is a form of public ruling, designed to provide an insight into the practical implications or detail of recently enacted law in ways that may go beyond mere questions of interpretation and that is binding on the Commissioner.
We highlight the following elements of the draft LCR which address particular aspects of Australia's low tax lender rule:

- **Ultimate parent entity (UPE) test -** As shown in Example 1, an entity can be a member of more than one control group for the purposes of the low tax lender rule. In our experience, this can be the case in some investment fund structures principally due to the operation of accounting consolidation rules to the general partner of a fund.

- **No or low tax test -** Whether payments are subject to foreign tax at a rate of 10 per cent or less is a key element in identifying a FIZLR. According to the draft LCR, where two countries impose tax on a payment, it is only the higher rate of tax that can be taken into account (viz. the cumulative tax cannot be taken into account). In addition, it is necessary to determine the foreign tax rate that would apply to the actual payment included in the tax base of the relevant country rather than, for example, the headline tax rate. Therefore, tax holidays, concessional rates of tax based on particular activities or status would all need to be taken into account.

- **Principal purpose test -** As noted above, in reaching a conclusion in relation to principal purpose it is necessary to have regard to three stipulated matters. However, in practice, applying this test to a wide range of circumstances has been challenging for some taxpayers, particularly where the factors may point in different directions. The draft LCR provides three examples in relation to this test and seeks to clarify some technical issues with the test. Overall, the Commissioner seems to be of the view that it will be difficult not to have a low or no tax principal purpose in circumstances where the FIZLR is funded to some extent with equity. In essence, the Commissioner's view appears to be that a banking, financial or other similar business must be almost entirely funded by debt and retained earnings. This aspect of the draft LCR is likely to be controversial and creates significant uncertainty for groups have genuine financing companies with substantial substance and activity but which may at least partially be funded with equity its parent.

- **Back-to-back rule -** This rule has been difficult to apply in many situations due to the lack of detail in the law as well as the general fungibility of funding.

  The draft LCR does provide some welcome confirmation that 'ordinary equity interests' would not be expected to be part of a back-to-back arrangement - this should mean that tracing is stopped by an 'equity wall'. However, the draft LCR suggests that it may be necessary to trace through an equity wall where relevant entities are part of a fiscal unity, consolidated group or otherwise subject to group relief. This aspect of the draft LCR is also likely to be controversial because it is not clear how this conclusion is available based on the statute.

  A major source of confusion and frustration with this rule has been deciding when loans have adequate nexus to require tracing - an arrangement is either back-to-back or it is not. According to the EM, it is expected that the terms of each loan to be connected and traced would be "*substantially the same*". This draft LCR attempts to address this issue and explains that "… *it is not essential that the terms of individual loans be identical and differences such as currency… and the amount of the loan would not necessarily mean loans could not be part of a back-to-back arrangement*" and that "*temporal connection between the loans is likely to be a significant factor … but again a disparity in issue dates would not of itself be conclusive that there is no back-to-back arrangement*". This additional guidance is somewhat helpful, but it will remain difficult in many real life circumstances to decide if a back-to-back arrangement exists.

  The draft LCR confirms that where a back-to-back arrangement exists, the low tax lender rule must be applied on the assumption that interest payments are made by the Australian taxpayer directly to the deemed FIZLR (viz to the ultimate recipient under the back-to-back arrangement).

Issues not addressed in the draft LCR

Unfortunately, the draft LCR does not address two other aspects of the low tax lender rule that are uncertain and have broad application:

- **CFC equivalent exemption -** An exemption is available for payments made to a FIZLR where the law of a foreign country that has 'substantially the same effect' as the Australian CFC rules applies. Following US tax reform, almost all income of CFCs of US headquartered companies are subject to current tax and the ATO has been asked to confirm whether this should activate the CFC equivalent exemption.

- **Assumed payment to UPE -** An exemption is available where a payment is hypothetically assumed to be made to the UPE and, in essence, the payment would be subject to foreign income tax at a rate that is the same as or less than the rate applicable to the FIZLR. The draft LCR does not address how the various low tax lender tests should be applied to any such hypothetical situation. There is also no guidance on how this rule applies where the UPE is, for example, a tax exempt foreign state-owned enterprises.

The takeaway

Any taxpayers that may be funded, directly or indirectly, by loans or derivatives from jurisdictions with tax rates of 10% or less or jurisdictions that may offer tax concessions should revisit their positions based on the draft LCR.

This requires urgent attention because, in many cases, identifying offshore no or low tax jurisdictions connected with the funding of Australia may be a difficult and time consuming task (including where foreign fiscal unity, consolidation or group relief arrangements are involved). However, the low tax lender rules applies to interest and some other financing costs for tax years commencing after 31 December 2018 (i.e. from as early as 1 January 2019 for calendar year taxpayers and 1 July 2019 for fiscal year taxpayers).

Comments on the draft LCR are due to the ATO by 10 May 2019.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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