Australia's hybrid mismatch rules - updated draft law released

9 March 2018

Explore more insights 365®

In brief

On 7 March 2018, the Australian Government released for comment a revised version (180 pages) of exposure draft legislation and explanatory materials to implement the Organisation for Economic Co-operation and Development (OECD) recommended hybrid mismatch rules as originally announced in May 2015.

Hybrid mismatches are differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions. If a mismatch arises, it is neutralised by disallowing a deduction or including an amount in assessable income.

This latest exposure draft updates the incomplete draft legislation previously released for comment on 24 November 2017, and also incorporates rules to address branch mismatch arrangements and to introduce a unilateral 'integrity rule' designed to discourage foreign interposed zero or low tax rate entities lending to Australia. For further background on the initial draft law, refer to our TaxTalk Alert, which was published on 27 November 2017.

The commencement date of the proposed rules is subject to the legislative process. However, with comments on the current exposure draft law not due until 4 April 2018, based on Parliamentary timetables, it would appear that any law cannot be introduced until the Winter session of Parliament which commences on 8 May 2018.

Background

The introduction of rules in Australia designed to eliminate hybrid mismatch arrangements was foreshadowed by the Australian Government in the May 2015 Federal Budget when it asked the Board of Taxation to consult on the implementation of the new laws, pursuant to the recommendations of the G20 and OECD under Action 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan.

Based on OECD recommendations released in September 2014, and finalised in October 2015, the rules were intended to apply to all payments made on or after the later of 1 January 2018 or six months after the relevant law is enacted. The Government estimated that the hybrid mismatch rules would have an 'unquantifiable gain to revenue'.

It was later announced in the May 2017 Federal Budget that the hybrid mismatch rules would also apply to regulatory capital of banks and financial institutions.

The OECD released a draft report in relation to branch mismatch arrangements in August 2016, which was finalised in July 2017.

A number of countries, including Germany, Japan, Mexico, Netherlands, Norway and South Africa, have implemented hybrid mismatch rules but none of these align with the full OECD recommendations. The United Kingdom introduced hybrid mismatch rules, with effect from 1 July 2017, largely based on the OECD recommendations. The United States has introduced limited hybrid mismatch rules applicable from 1 January 2018. New Zealand has introduced legislation into Parliament which includes OECD-style hybrid mismatch rules from 1 July 2018. And, twenty eight EU member states plan to introduce hybrid mismatch rules from 1 January 2020.

In detail

The latest version of draft law is broadly consistent with the recommendations of the BEPS Action Plan, but there are some departures which will be important to understand. The rules are complex and require an enquiry into the operation of foreign tax rules. The draft law introduces a number of new concepts and gives rise to a number of unanswered questions, particularly in relation to the interaction of the new hybrid mismatch rules with Australia's existing international tax rules.

However, in simple terms, the hybrid mismatch rules seek to neutralise circumstances where cross-border arrangements give rise to payments (including, for example, interest, royalties, rent, dividends and, in some cases, amounts representing a decline in the value of an asset) that:

1) are deductible under the tax rules of the payer, and not included in the income of the recipient (deduction/no inclusion or 'D/NI outcome'); or

2) give rise to duplicate deductions from the same expenditure (double deduction or 'DD outcome').

If arrangements give rise to a D/NI or DD outcome, the hybrid mismatch rules operate to eliminate the mismatch by, for example, denying a deduction or an income exemption (including franking credits). The rules mechanically allocate the taxation right in relation to a mismatch. The purpose of the arrangement, generally, should not affect the outcome.

For example, a tax deduction could be denied in Australia for royalties or interest paid to a foreign entity because that foreign entity is not taxed on the income it receives as a result of that foreign entity satisfying the definition of a hybrid entity. This denial would apply despite the Australian company satisfying other rules (e.g. transfer pricing and thin capitalisation) and the income being subject to Australian (withholding) tax.

The hybrid instrument rules could apply where, for example, an Australian company receives dividends from a foreign subsidiary. In this case, the Australian dividend exemption may be denied if the foreign subsidiary was afforded a foreign tax deduction for dividends paid to Australia.

In addition, the draft law includes imported hybrid mismatch rules which, in essence, seek to reduce or eliminate tax deductions for payments made by an Australian company which directly or indirectly funds a hybrid mismatch outcome in any country that has not adopted OECD hybrid mismatch rules. These rules can operate to deny deductions in Australia for a broad range of payments including rents, royalties, interest and fees for services.

Imputation benefits will be denied if a foreign income tax deduction is available in respect of a distribution. A transitional rule will be available for regulatory capital of an authorised deposit-taking institution or insurance company that was issued before 9 May 2017.

Unlike other recently enacted international tax measures in Australia, which are predominantly aimed at 'significant global entities' (SGEs) that exceed a global revenue threshold of AUD1 billion, there is no de minimis threshold.

Branches

The draft law released in November 2017 included only limited rules in relation to hybrid branch mismatches (that is, in relation to DD outcomes). The current exposure draft proposes further rules which will:

- Limit the foreign branch exemption (i.e. section 23AH of the *Income Tax Assessment Act 1936*) in respect of branch hybrid mismatches. In broad terms, a branch hybrid mismatch arises where the residence country provides a branch exemption, but the branch country does not tax the payment because the payment is treated as not derived in carrying on business through a permanent establishment.
- Disallow a tax deduction for payments that give rise to a branch hybrid mismatch for the payee.
- Disallow tax deductions for interest in respect of notional borrowings and payments, in respect of notional derivative transactions for Australian branches of foreign banks that have not chosen to opt out of the deeming rules in Part IIIB of the *Income Tax Assessment Act 1936*.

New Integrity Rule

As explained in the 2015 OECD report: *"The recommendations in the report…are not intended to capture payments made to a person resident in a no-tax jurisdiction"*. In addition, the OECD recognised *"the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations"*.

However, despite these OECD recommendations, in November 2017 the Australian Government announced a rule that would apply to 'financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax'. In other words, the Government decided to enact a unilateral tax measure that is out of step with the OECD BEPS recommendations.

In simple terms, this new unilateral measure is designed to override the hybrid mismatch rules and impose additional Australian tax on interest and derivative payments to foreign interposed zero or low rate (FIZLR) lenders, irrespective of whether the arrangement is a hybrid. The proposed 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 to a foreign interposed group entity;
- the interposed foreign entity and the ultimate parent entity are not residents of the same foreign country;
- the Australian entity, the interposed group entity and the ultimate parent 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; and
- the payment is subject to foreign income tax at a rate that is 10 per cent or less (or not subject to foreign income tax).

However, deductions will not be denied if it is reasonable to conclude any of the following conditions are satisfied:

- the payment is income under the controlled foreign company (CFC) rules of Australia or another country.
- assuming that the payment had been made directly to the ultimate parent entity, the payment would be subject to foreign income tax at a rate that is the same as, or less than, the interposed country rate and the payment would not give rise to a hybrid mismatch.
- the scheme was not designed to produce an Australian income tax deduction and the imposition of foreign income tax on the payment at a rate of 10 per cent or less.

There is also a back-to-back rule which provides that the rules will be applied on a look-through basis for 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. In these circumstances, for the purposes of testing the application of the FIZLR rule, the Australian entity will be treated as having made the payment directly to the foreign entity.

Restructuring

In almost all cases, simply allowing the hybrid mismatch rules to apply to existing arrangements will not be a viable option for various reasons (e.g. the risk of withholding tax on non-deductible interest, impact on thin capitalisation and transfer pricing). Therefore, Australian taxpayers with hybrid mismatches will need to consider their options which is likely to involve restructuring to comply with the rules in order to remove adverse outcomes. The OECD report had anticipated that taxpayers would "restructure existing arrangements to avoid any adverse tax consequences associated with hybridity".

The draft Explanatory Memorandum recognises that *"…many taxpayers will restructure out of hybrid arrangements and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules"*. In addition, it is stated that a restructure that, for example, *"…could result in retaining a deduction [in Australia] with a greater amount being included in a foreign income tax base…would satisfy the objective of the hybrid mismatch rules"*.

Other Changes

A number of aspects of the rules have been enhanced and clarified in this latest exposure draft. These include:

- The **dual inclusion income rule**, which has been expanded and clarified. This rule is important because no adjustment might be required despite the existence of hybridity to the extent dual inclusion income exists.
- The **'subject to tax' concept**, which has been expanded to explain the impact of, for example, tax losses and foreign tax credits on this test.
- The **test that is used to determine if a mismatch is due to hybridity**, which has been modified to more closely align with OECD concepts.
- A rule which has been introduced to deal with **deductible REIT distributions**.
- There has also been clarification in relation to **the interaction of the hybrid mismatch rules with the CFC, foreign exchange and the taxation of financial arrangement (TOFA) rules**, and
- **Regulatory capital rules** have been extended to insurance companies.

When will the new rules commence?

The new law seems to apply to payments made six months after the relevant amending Bill is enacted (although the drafting is not clear on this important aspect), which is inconsistent with the OECD recommendation that *"… to avoid unnecessary complication and the risk of double taxation, the rules should generally take effect from the beginning of a taxpayer's accounting period"*.

With the deadline for comments on the current exposure draft law not due until 4 April 2018, it is clear that the measures will not be introduced into Federal Parliament in the current Autumn sitting which is scheduled to end on 28 March 2018. Since both Houses of Parliament will not then next sit until the week commencing 8 May 2018, it is reasonable to expect that the new law could not apply to any payments made before 8 November 2018.

Since finalisation of the new law is subject to the Parliamentary process, which is difficult to predict, a commencement date of 1 January 2019 seems most likely at this stage.

The takeaway

We recommend that all Australian taxpayers with cross-border transactions consider the potential impact of the hybrid mismatch rules sooner rather than later. This will include the identification of any FIZLR lenders notwithstanding no hybrid element exists. From experience in other countries, as well as from the draft rules released in November 2017, identifying potential hybrid mismatches is not straightforward. This exercise becomes even more complex as countries introduce hybrid mismatch legislation which does not align with the OECD recommendations.

In addition, restructuring out of hybrid arrangements and entering into alternative arrangements that do not attract the operation of hybrid mismatch rules will be a necessity for many taxpayers. This will require careful consideration of legal, accounting, treasury and foreign tax issues, and timing will be tight given the wide range of complexities involved.

Let's talk

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

Michael Bona, Brisbane
+61 (7) 3257 5015
michael.bona@pwc.com

Peter Collins, Melbourne
+61 (3) 8603 6247
peter.collins@pwc.com

Angela Danieletto, Sydney
+61 (2) 8266 0973
angela.danieletto@pwc.com

Chris Morris, Sydney
+61 (2) 8266 3040
chris.j.morris@pwc.com

Michael Taylor, Melbourne
+61 (3) 8603 4091
michael.taylor@pwc.com

Grant Harrison, Sydney
+61 (2) 8266 1986
grant.harrison@pwc.com

Sarah Hickey, Sydney
+61 (2) 8266 1050
sarah.a.hickey@pwc.com