Hybrid mismatch restructures and general anti-avoidance rules – draft ATO guidance

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In brief

On 21 June 2018, the Australian Taxation Office (ATO) released a draft Practical Compliance Guideline (PCG 2018/D4) which considers the application of the general anti-avoidance provisions (Part IVA of the *Income Tax Assessment Act 1936*) in the context of restructures to deal with the new rules for hybrid mismatch arrangements.

The hybrid mismatch legislation that was introduced into Federal Parliament on 24 May 2018 gives effect to the Organisation for Economic Co-operation and Development's (OECD) recommended hybrid mismatch rules. These rules are generally intended to take effect for income years commencing on or after 1 January 2019.

Hybrid mismatches arise from differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions. In addition, Australia proposes to introduce as an integrity measure, a unilateral low tax rate (10 per cent or less) lender rule.

The draft PCG provides guidance on the ATO's compliance approach to the application of general anti-avoidance provision (Part IVA) to restructures that have the effect of preserving Australian tax benefits that would otherwise be disallowed under the hybrid mismatch rules.

The purpose of the draft PCG is to assist taxpayers to manage their compliance risk by outlining straightforward (low risk) restructuring to which the Commissioner of Taxation will not seek to apply Part IVA. The draft PCG also provides examples of 'higher risk' restructuring that will not preclude scrutiny of the arrangement if it is one that otherwise has features of artificiality or contrivance. No guidance has been provided in the draft PCG in relation to restructuring involving the low tax lender or the imported mismatch rules.

In detail

Background

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 applicable to 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 an arrangement gives 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 legislation also includes imported hybrid mismatch rules which, in essence, seek to reduce or eliminate tax deductions for payments made by an Australian entity which directly or indirectly fund a hybrid mismatch outcome in any country that has not adopted OECD hybrid mismatch rules.

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

Further information on the scope of the hybrid mismatch and low tax rate lender rules can be found in our TaxTalk Alert published on 28 May 2018.

Restructuring to address hybrid mismatch arrangements

Based on experience to date, our expectation is that, in almost all cases, simply allowing the hybrid mismatch or low tax lender 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 will need to consider their options, which is likely to involve the restructure of existing hybrid arrangements to limit the potential application of the hybrid mismatch rule.

Restructuring to remove hybridity seems to be the clear intent and expectation of the legislation. The Explanatory Memorandum (EM) to the Bill introducing the new law explains that '… many taxpayers will restructure out of hybrid arrangements that would otherwise be subject to the OECD hybrid mismatch rules (including arrangements subject to the [low tax lender] rule) 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'.

The Commissioner's compliance approach

The draft PCG is split into the following three sections:

- The ATO's compliance approach to Part IVA and arrangements that are restructured to address hybrid mismatches
- Identification of 'low risk' scenarios and associated examples, and
- Examples of 'higher risk' scenarios.

ATO's compliance approach to Part IVA and restructures to address hybrid mismatches

The draft PCG highlights that restructures which result in the elimination of a hybrid mismatch and the preservation of an Australian tax benefit may not attract the operation of Part IVA. Instead, it is important to consider whether the arrangements should be considered 'ordinary commercial dealings' of the taxpayer.

However, there is an expectation that where there is the elimination of a hybrid mismatch which results in the preservation of the Australian tax outcomes, the 'tax benefits in the foreign counterparty jurisdiction will no longer be available'. The draft PCG does not explain the basis for this expectation.

The draft PCG also explains that it should not be assumed that restructuring arrangements in anticipation of the rules will not necessarily be considered low risk and not subject to scrutiny by the ATO merely because they were entered into prior to enactment of the hybrid mismatch rules, particularly where such arrangements continue to be carried out and given effect after enactment.

Identifying low risk' scenarios

The draft PCG identifies the following six assumptions that must apply to all scenarios that are considered to be low risk:

- No change to the jurisdictions of the entities involved under the replacement arrangement.
- The original arrangement makes commercial sense for the parties involved (i.e. it would not have attracted the application of Part IVA).
- The replacement arrangement makes commercial sense for the parties involved.
- The restructure and replacement arrangement are effected in a straightforward way having regard to the circumstances.
- The restructure and replacement arrangement are implemented on arm's length terms.
- The replacement arrangement is otherwise tax effective (i.e. a tax benefit is preserved).

Importantly, if one or more of these assumptions does not apply the arrangement cannot qualify as low risk.

Where, after considering the relevant facts and circumstances, the ATO considers the arrangement to be 'low risk', the draft PCG indicates that the Commissioner would not seek to apply Part IVA.

Four examples are provided in the draft PCG that satisfy these assumptions, and are therefore considered to be low risk:

- Replacement of inbound hybrid preference shares with interest bearing debt
- Replacement of an outbound hybrid profit performing loan with ordinary equity
- Reorganisation of the ownership of a deducting hybrid Australian partnership
- Refinancing a deducting hybrid foreign partnership.

In each of these examples, the Australian tax outcome is preserved and the foreign tax benefit is removed. In addition, each example involves straightforward restructuring that merely removes the hybrid element whilst keeping the surrounding facts and circumstances unchanged.

Examples of 'higher risk' arrangements

Two examples are provided in the draft PCG of arrangements that, whilst removing the hybrid element of the arrangement, may nonetheless attract the application of Part IVA. These include:

- Removing a hybrid mismatch that previously produced a foreign income tax deduction but, due to accumulated losses in a foreign company, the new arrangement results in the same foreign (and Australian) tax outcome; and
- The interposition of a third company which is resident in a low tax ('substantially lower rate' of corporate tax as compared to the original lender and Australia) country. This example is difficult to follow because it 'disregards the potential application of the [low tax lender] rule', which seems intended to sanction the interposition of lenders with a headline tax rate of more than 10 per cent.

As the restructuring in these examples is not straightforward, i.e. it goes further than merely removing the hybrid element, and does not accord with all of the six required assumptions, the ATO would consider these to be 'higher risk' from a compliance perspective. The draft PCG reminds taxpayers that a ruling could be obtained in relation to restructures that are not covered by the low risk scenarios.

The draft PCG notes that some taxpayers may be required to disclose information about hybrid arrangements or any restructures in the Reportable Tax Positions (RTP) schedule.

The ATO has invited comments in relation to the draft PCG by 20 July 2018.

The takeaway

The views expressed in the draft PCG may provide welcome reassurance for taxpayers that are able to restructure in a manner that satisfies all of the assumptions required to qualify as a low risk restructure.

However, we anticipate that, in many circumstances, it will not be commercially possible for a taxpayer to undertake a restructure that satisfies all of the required assumptions. In these circumstances, it will be important to demonstrate that the restructure does not contain elements that could attract the operation of Part IVA, and it will be critical to ensure that there is sufficient evidence to discharge the taxpayer's burden of proof.

In addition to the Part IVA aspect highlighted by the draft PCG, restructuring out of hybrid arrangements and FIZLR entities and into alternative arrangements will require careful consideration of a range of issues including legal (including Foreign Investment Review Board), transfer pricing, accounting, treasury, withholding taxes, losses, foreign tax credits, stamp duty and foreign tax issues. Timing will be tight in many cases given the wide range of complexities involved.

Let's talk

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

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