Draft law on Australia's hybrid mismatch rules

27 November 2017

In brief

On 24 November 2017, the Australian Government released for comment exposure draft legislation and explanatory materials (115 pages) 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 neutralized by disallowing a deduction or including an amount in assessable income.

The commencement date of the proposed rules is not entirely clear and subject to the legislative process. However, based on Parliamentary timetables, this can be no earlier than 5 August 2018. There is no grandfathering of existing arrangements.

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. New Zealand has announced plans for OECD style hybrid mismatch rules from 1 July 2018 and 28 EU member states plan to introduce hybrid mismatch rules from 1 January 2020.

In detail

The exposure draft legislation is broadly consistent with the OECD recommendations but there are some departures which will be important to understand. The draft legislation is complex and requires an inquiry into the operation of foreign tax rules. It 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) 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 and the purpose of the arrangement does not affect the outcome.

For example, a tax deduction could be denied in Australia for royalties 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 hybrid entity. This denial would apply despite the Australian company satisfying other rules (e.g. transfer pricing) 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 fund 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 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 A$1 billion, the draft hybrid mismatch rules do not have a gateway threshold or a de minimis threshold.

Although not included in the current exposure draft, the Government announced that it will also implement rules to address branch mismatches. The branch mismatch rules will be the subject of separate exposure draft legislation and consultation. However, the rules will commence at the same time (that is, six months after Royal Assent of the Bill that introduces the hybrid mismatch rules). This could mean that taxpayers affected by the branch mismatch rules have less time to assess the impact of the rules and, where necessary, restructure.

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. In fact, the OECD report anticipated that taxpayers would "restructure existing arrangements to avoid any adverse tax consequences associated with hybridity".

The exposure draft does not address this important aspect. However, the Minister's Media Release includes the following:

"Following the introduction of the hybrid mismatch rules, multinational groups investing into Australia may seek to achieve double non-taxation outcomes by using investment structures and arrangements that may not fall within the scope of the OECD's hybrid mismatch rules. For example, foreign headquartered groups investing into Australia may use financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax.

The Government is concerned that such arrangements would undermine the integrity of the hybrid mismatch rules and will therefore be developing a targeted integrity rule to ensure such arrangements cannot be used to circumvent the hybrid mismatch rules".

It is unfortunate that the detail of this critical rule has not been included in the exposure draft legislation, particularly given the OECD provides no guidance on this initiative as it is not a formal recommendation of the OECD.

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 "In order 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".

Parliament is not scheduled to resume its sittings next year until 5 February 2018 and therefore it is clear that the new law will not apply to payments before 5 August 2018.

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. From experience in other countries, identifying hybrid mismatches, particularly under the imported hybrid mismatch rule, is not straightforward and taxpayers affected by the branch mismatch rule may have even less time to prepare. In addition, restructuring will require careful consideration of legal, accounting, treasury and foreign tax issues. Timing will be tight given the wide range of complexities involved.

Comments on the exposure draft law are required to be submitted to Treasury by 22 December 2017.

Let's talk

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