

More ATO guidance on hybrid mismatch rules - structured arrangements

20 December 2018

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In brief

On 19 December 2018, the Australian Taxation Office (ATO) issued further draft guidance (in the form of a Law Companion Ruling (LCR) and a Practical Compliance Guideline (PCG)) on the application of the hybrid mismatch rules, this time specifically dealing with the scope of the rules in relation to certain payments that are made between related or unrelated parties under a “structured arrangement”.

Law Companion Ruling, [LCR 2018/D9](#), once finalised will be binding on the Commissioner and seeks to set out the Commissioner’s view of the hybrid mismatch law in relation to the phrase “structured arrangement” and “party to the structured arrangement”. The LCR should be read in conjunction with Practical Compliance Guideline [PCG 2018/D9](#) which was simultaneously released and which sets out the Commissioner’s practical approach for taxpayers to assess their risk of the new rules applying to their circumstances. The concept of structured arrangement is relevant for determining whether certain transactions are within the scope of the hybrid mismatch rules.

A critical aspect of this guidance is that it clarifies the ATO’s views on when an imported mismatch may be considered to be “structured”. This impacts the start date for the application of the imported mismatch rules in respect of a particular arrangement. The imported hybrid mismatch rules generally have a deferred start date of no earlier than 1 January 2020, but only if the imported mismatch is a “non-structured” arrangement (otherwise the earlier start date of 1 January 2019 applies). An imported mismatch broadly can arise where an Australian entity has no direct hybrid arrangements but where payments made by the Australian entity for ordinary expenses ultimately ‘fund’ a hybrid mismatch offshore. The draft PCG contains a specific example of how the structured arrangement rules may apply in an imported hybrid mismatch scenario within a MNC group which means Australian taxpayers (who may not even be aware of the existence of the offshore mismatch) will need to apply the imported mismatch rules from 1 January 2019.

The PCG also has some other examples which should provide some comfort for securitisation vehicles and for Australian third party borrowers that ordinary third party commercial dealings may remain outside the scope of the hybrid mismatch rules. However, the particular facts need to be reviewed against the detail in the draft LCR and PCG to assess whether the particular arrangement is on ‘all fours’ with the examples provided.

This Tax Talk Alert provides a high level summary of the issues covered by the draft LCR and PCG.

Significance of the guidance

Taxpayers who may have taken a view that the imported mismatch rules are deferred until 1 January 2020, and that the Australian impacts of this aspect of the hybrid rules may be largely negated by global restructures occurring during 2019 to remove offshore hybrid mismatches to comply with the EU hybrid

rules which start in 2020, will need to carefully consider their position to determine whether deductions for ordinary business expenses such as cost of goods sold, service fees and royalties will be denied from 1 January 2019.

While some of the examples in the draft PCG are helpful to confirm that deductions under ‘vanilla’ third party transactions may not attract the application of the hybrid rules, it is likely that many arrangements will not fall squarely within those set out in the ATO’s “white zone” examples and careful consideration will need to be given to the specific factors set out in the draft LCR and PCG.

In detail

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).

LCR 2018/D9 and PCG 2018/D9 consider the concept of a “structured arrangement” which is relevant for determining the scope for the rules to apply in circumstances where a payment is made under a “structured arrangement” to which the entity is a party. Specifically, this is critical for determining:

- whether the hybrid mismatch rules can apply to certain transactions where the entities are not related persons or part of a control group; and
- how the imported mismatch rules apply, and importantly, whether the imported mismatch rules apply to arrangements for income years commencing on or after 1 January 2019 or 1 January 2020 (which is the start date for non-structured imported mismatch arrangements).

In brief, the structured arrangement concept is satisfied in respect of a payment giving rise to hybrid mismatch where:

- the hybrid mismatch is ***priced into the terms of a scheme*** under which the payment is made, or
- it is reasonable to conclude that the hybrid mismatch is a ***design feature*** of a scheme under which the payment is made.

The draft LCR sets out the Commissioner’s views on each of the above aspects.

The draft PCG sets out the Commissioner’s practical approach that will be relevant for taxpayers to assess their risk of the new rules applying to their circumstances. In broad terms, PCG 2018/D9 sets out the Commissioner’s views on the following issues:

- The testing time of whether a scheme is a structured arrangement:

Depending on the facts and circumstances, the testing time may be when the scheme is initially entered into, or for a pre-existing scheme, it may be the first time a payment is made under that scheme in an income year commencing on or after 1 January 2019. A subsequent change in pricing or design features, or a significant change in external factors may require re-testing.

- Relevant indicators that would suggest a hybrid mismatch is “priced into the terms” of a scheme under which a payment is made:

This may include features such as a formula that explicitly references the tax rate of one of the parties, pricing that is divergent from market rates where the difference is readily explicable to a hybrid mismatch, a gross-up clause representing compensation for any additional tax payable where a hybrid mismatch turns out to not be available, a renegotiation clause allowing a party to alter pricing or a break clause allowing termination if a hybrid mismatch benefit does not

materialise, or pricing on a product widely offered but only taken up in a particular jurisdiction explicable by reference to a hybrid mismatch outcome in that jurisdiction.

- Relevant indicators that the hybrid mismatch is a “design feature” of the scheme:

Factors (either on a stand-alone basis or in combination) include advice sought regarding planning to produce a hybrid mismatch, a term/step/transaction included in the scheme explicable by reference to a hybrid mismatch, an arrangement or investment marketed as a tax advantaged product where some or all of the tax advantage is explicable by reference to a hybrid mismatch, a product only offered or marketed to a particular subset of prospective investors that would be expected to benefit from such a hybrid mismatch, a transaction chain traceable directly or indirectly from the deductible importing payment to an offshore hybrid mismatch.

- Information that the Commissioner will rely on and would expect to be available to taxpayers in determining if they are a party to the structured arrangement:

Whether an entity is a party to a structured arrangement is an objective test largely based on the information available to the taxpayer. The Commissioner’s view is that this test would not impose an obligation on a taxpayer to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable person making a risk versus return assessment. It should be reasonable to expect that a taxpayer should have access to information relating to their own dealings including correspondence, terms of an instrument or arrangement, advertising, public documentation such as a prospectus or investment memorandum, location and perhaps tax residence of transaction counterparties and some awareness of market pricing of their risk/return position.

The draft PCG also sets out four examples of how the structured arrangement rules may apply in various circumstances. The first three are transactions between unrelated parties and the last one deals with transactions within a group:

1. A hybrid financial instrument mismatch arrangement where the hybrid benefit is explicitly priced into the instrument - *this example confirms that where the terms of the instrument factor in the hybrid tax benefit between the borrower and lender (i.e. part of the interest rate calculation), that should be a structured arrangement.*
2. A widely distributed securitisation arrangement where the lowest ranked tranche of notes give rise to timing mismatch between Australia and an investor country - *the example suggests that where the notes are marketed and taken up widely, and there is consistent pricing across jurisdictions, there should not be a structured arrangement.*
3. A reverse hybrid mismatch scenario involving an Australian company that borrows money on commercial terms from an unrelated foreign collective investment vehicle (CIV), where the CIV has marketed its investment structure as a tax advantaged product to investors in certain countries - *this example highlights that while there may be a structured arrangement, an Australian third party borrower should generally not be a party to any such arrangement where it is not aware of and does not benefit from the hybridity, and the Commissioner will not expect the Australian borrower to undertake additional due diligence above and beyond what would be reasonably expected as part of an ordinary commercial due diligence in this instance regarding risk and reward in relation to its own financial position.*
4. Imported hybrid mismatch arrangement involving a cost of goods sold (COGS) payment made to a reverse hybrid arrangement further up the chain in a wholly owned global group context - *the example suggests where there is an offshore mismatch within a multinational group, it may be very difficult to argue that an imported mismatch was non-structured. It suggests based on the facts in the example, unless the hybrid was ‘inadvertent’ it would be very difficult to say it was not a design feature of the scheme.*

The takeaway

This latest guidance material from the ATO adds to the previously issued PCG 2018/7 which dealt with the Commissioner's approach to the general anti-avoidance provisions and restructures implemented to preserve the Australian tax benefits that would otherwise be disallowed under the hybrid mismatch rules (see our [TaxTalk Alert](#) dated 31 October 2018). We also expect further guidance on these complex rules to come from the ATO in 2019 including in relation to the hybrid mismatch targeted integrity rule and also on its foreign law interactions.

Comments can be made on both the draft PCG and the draft LCR by 15 February 2019.

With the hybrid mismatch rules applying from 1 January 2019 for December balancing taxpayers, time is definitely fast running out to not only identify potential hybrid mismatch structures, but also to assess and appropriately respond to existing arrangements in place.

Let's talk

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

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