Draft hybrid mismatch rules: potential impacts for real estate and infrastructure investments

7 December 2017

In brief

As currently drafted, the proposed Australian hybrid mismatch rules (released on 24 November 2017) may have a significant impact on Australian inbound and outbound real estate and infrastructure investment structures. These structures often involve cross-border debt and the use of trusts which may, in certain circumstances, give rise to hybrid mismatches. The draft legislation is designed to eliminate hybrid mismatches by disallowing a deduction or including an amount in assessable income.

We anticipate that many outbound real estate and infrastructure entities may also be impacted by the proposed law, which seeks to treat certain foreign equity distributions received by an Australian company (that are currently not subject to tax in Australia) as taxable where it gives rise to a deduction in a foreign jurisdiction. Further, recipients of a franked distribution will be denied access to imputation benefits on the distribution if the Australian payer was entitled to claim a tax deduction in respect of any part of the distribution in a foreign country.

Overall, the proposed rules are complex and require an inquiry into the foreign tax treatment of the relevant payments/receipts. We anticipate the proposed law may create uncertainties for many inbound and outbound real estate and infrastructure entities as it introduces a number of new concepts and gives rise to a number of unanswered questions.

In addition to the draft rules, the Government has also announced that it will be developing a targeted integrity rule to ensure taxpayers cannot circumvent the application of the proposed law, for example by investing through interposed entities in zero tax rate countries. The Government will also implement the Organisation for Economic Co-operation and Development's (OECD) recommended hybrid mismatch rules, which seek to address double non-taxation outcomes arising because of the different taxation treatments of dealings within the same legal entity (e.g. between head office and a foreign branch).

All inbound and outbound entities should consider the potential application of these proposed rules as unlike other recently enacted international tax measures in Australia, which are predominantly aimed at 'significant global entities' with a global revenue threshold of at least AUD1 billion, the draft hybrid mismatch rules do not have the same de minimis threshold. There is also no grandfathering of existing arrangements. The commencement date of the proposed rules is unclear and subject to the legislative process. Based on Parliamentary timetables, the rules are unlikely to come into effect before 5 August 2018.

For further information and background about the draft hybrid mismatch rules in Australia, see our TaxTalk Alert: Draft law on Australia's hybrid mismatch rules, which was issued in November. This TaxTalk Alert seeks to provide further insights into the potential application of the draft rules to Australian inbound and outbound real estate and infrastructure entities.

In detail

Overview of the draft hybrid mismatch rules

Broadly, a 'hybrid mismatch' arises where there is a cross-border arrangement involving a 'payment' (including for example, interest, royalties, rent, dividends) that gives rise to one of the following hybrid outcomes:

- **deduction/non-inclusion or 'D/NI mismatch'** – the payment is deductible when working out the tax base of the payer, but not included in the tax base of the recipient within 12 months after the relevant income year in which the payments are deducted. In this scenario, the mismatch is taken to be the difference between the amount deductible to the payer and the amount included in the tax base of the recipient within the specified timeframe; or
- **double deduction or 'DD mismatch'-** the payment gives rise to duplicate deductions in a foreign country and in Australia or another foreign country. In this case, the mismatch is taken to be the lesser of the deduction amounts in the two jurisdictions.

A 'payment' is deemed to have been made for the purposes of the hybrid mismatch rules if an entity has an entitlement to receive a payment or a non-cash benefit. That is, the draft legislation captures amounts that are deductible on an accruals basis as opposed to a realisation basis.

Tax base

An amount is taken to be deducted in working out the tax base of an entity if it is applied to reduce the amount of tax payable by the entity in the relevant country in any way (e.g. a straight deduction, or where it reduces a net amount that is included in the taxable income of the entity). On the other hand, an amount is included in the tax base of an entity if the amount is taken into account in working out the amount (including nil amount) of foreign income tax (excluding withholding tax) payable by the entity. Unlike under the diverted profits tax rules, the tax rate applicable in the relevant country appears to be irrelevant for this purpose. For further explanation, please also refer to the comments on zero tax rate jurisdictions below.

Types of hybrid mismatch

Notwithstanding the existence of a hybrid outcome noted above, the above hybrid outcomes must arise as a result of one of the following mismatches (in the order of priority) for the hybrid mismatch rules to apply. This means that any hybrid outcomes that arise as a consequence of a matter other than the different tax treatments of an instrument, an entity, or as a result of an imported hybrid, are not intended to be captured under these rules. For example, the hybrid mismatch rules should not apply where the mismatch is solely attributable to the tax exempt or concessional tax status of an entity in a particular country (e.g. exempt pension fund).

1. **Hybrid financial instrument mismatch**. Broadly, where a payment made under a debt interest, an equity interest, a derivative financial arrangement or an arrangement to transfer a financial instrument results in a D/NI mismatch as a result of the differences in the treatment of the relevant financial instrument under the tax law of two jurisdictions because of the terms of the instrument, but not because one country chooses, for example, not to tax that amount.

2. **Hybrid payer mismatch**. Broadly, where a payment made by a payer is disregarded for the purposes of the tax law of one country, but is deductible for the purposes of the tax law of another country. For example, where an Australian tax resident company that is checked open for US tax purposes makes a payment to its US parent company.

   The mismatch amount arising under this is reduced to the extent that there is a 'dual inclusion income', which is broadly an amount of income or profits that is subject to income tax in two jurisdictions unless a foreign tax credit (other than for a withholding type tax) is available in respect of that amount. In addition, the dual inclusion income must be subject to income tax in the jurisdiction where the relevant deduction (that gives rise to the mismatch) is claimed and in the same income year that the deduction arises.

3. **Reverse hybrid mismatch**. Broadly, where a payment is attributable to an entity that is treated as a transparent entity under the tax law in the country of formation, but non-transparent under the tax law of the country in which the investors in it are subject to tax, resulting in non-inclusion.

4. **Deducting hybrid mismatch**. Broadly, where a particular payment made by the payer is deductible under the tax laws of two different countries, resulting in double deductions. In this circumstance, the hybrid mismatch rules would seek to deny the deduction in Australia only where Australia is the primary response country (i.e. the entity is resident in Australia), or where Australia is the secondary response country and the primary response country does not have hybrid mismatch rules.

   The mismatch amount arising in this scenario is reduced to the extent that there is a 'dual inclusion income'.

5. **Imported hybrid mismatch**. An imported hybrid mismatch is an integrity measure aimed at stopping arrangements that seek to avoid the application of the hybrid mismatch rules by interposing entities between different jurisdictions. In essence, the imported hybrid mismatch rules seek to reduce or eliminate tax deductions for payments made by an Australian entity (through interposed entities) to an offshore entity that can claim a deduction in respect of a payment that gives rise to a hybrid mismatch.

   This could occur, for example, where there is a chain of entities (say For Co 1, For Co 2 and Aus Co) and there is a hybrid financial instrument between For Co 1 and For Co 2 which gives rise to a foreign income tax deduction for For Co 2 and non-inclusion for For Co 1. Where Aus Co makes a deductible payment to For Co 2, the imported hybrid mismatch rule may apply to deny Aus Co's deduction because it is funding the For Co 2 hybrid mismatch deduction.

   These rules appear to have a broad application as it is not necessary to demonstrate that the payment made by the Australian entity directly funds the offshore payment that gives rise to a hybrid mismatch. It is sufficient that there are payments between each interposed entity. The rules also capture a broad range of payments including rents, royalties, interest and fees for services.

It is noted that in each of the above circumstances, there could only be a hybrid mismatch where there is a 'structured arrangement' that the relevant entity is a party to, or where the relevant entities are in the same 'Division 832 control group' (or are related parties for the purposes of the hybrid financial instrument mismatch). Whether or not there is a 'structured arrangement' that an entity is a party to requires consideration of the relevant facts and circumstances. However, given the broad definition of the terms, there may be only limited circumstances where an entity could argue that there is no such 'structured arrangement' or that they are not 'a party to a structured arrangement'.

Where the proposed hybrid mismatch rules apply, the rules operate to eliminate hybrid mismatches by either disallowing a deduction or an income exemption, or including an amount in assessable income. The rules mechanically allocate the taxation right in relation to a mismatch, and the purpose of the arrangement does not affect the outcome.

Proposed amendment to Subdivision 768-A

In addition to the introduction of the hybrid mismatch rules, an amendment is proposed to be made to Subdivision 768-A dividend participation exemption. In essence, the dividend exemption will not be available if the foreign company that made the 'foreign equity distribution' is entitled to claim a deduction in the foreign jurisdiction.

This proposed amendment would have a significant impact on Real Estate Investment Trust (**REIT**) structures used around the world. Currently, certain REITs which make an equity distribution to an Australian company may be entitled to claim a deduction for that distribution under the tax law of their foreign jurisdiction. Such distribution may however, not be assessable in Australia due to the current application of Subdivision 768-A where the Australian company holds a 10 per cent or more participation interest in the REIT. Under this proposed amendment, the Australian company would be subject to tax on the distribution received from those REITs.

Denial of imputation benefits on deductible franked distributions

The proposed law also denies the recipient of a franked distribution access to imputation benefits if the Australian company that made the distribution was entitled to claim a tax deduction in respect of all or part of the distribution in a foreign country. This means that the recipient will not be required to include the franking credit attributable to the distribution in its assessable income, nor will it be entitled to a tax offset for the franking credit attached to the distribution.

It will be interesting to see how this proposed law will be applied in practice, particularly as the limitation is placed on the recipients who may not have any knowledge of the tax treatment adopted by the Australian payer in respect of the distributions received. Should the draft rules become law, Australian companies may in fact choose to make relevant disclosures in the distribution statements issued to investors to address this.

Impacts on inbound and outbound real estate and infrastructure investments

The application of the rules to flow-through trusts and Managed Investment Trusts (MITs)

In each of the before mentioned hybrid mismatch scenarios, the proposed law requires the identification of a 'liable entity', which is broadly an entity where Australian tax or foreign income tax (other than withholding type tax) is imposed on the entity in respect of the income or profits of a 'test entity'. The test entity can either be the liable entity itself or another entity. The purpose of this definition is to ensure that taxpayers do not circumvent the application of the hybrid mismatch rules by flowing their income or profits through a transparent entity (such as a trust or partnership), which itself is not subject to tax.

The beneficiaries of a flow-through trust or a MIT (provided they are not beneficiaries in the capacity of a trustee of another trust) will be the liable entities in respect of the income or profits of the flow-through trust or MIT. As a result, hybrid mismatches could still arise where the payer or recipient of an amount is a flow-through trust or a MIT.

For example, hybrid financial instrument mismatch could potentially arise where there is a hybrid financial instrument (e.g. Redeemable Preference Shares which terms give rise to different tax treatments, being a deduction for Australian tax purposes and non-assessable income in the foreign jurisdiction) between For Co 1 and its wholly-owned subsidiary For Co 2, and For Co 2 is the beneficiary of an

Australian trust (which is not a MIT). Under the proposed hybrid mismatch rules, For Co 2 may have its deductions denied for the purposes of calculating its taxable income for Australian income tax purposes.

In another example, a deducting hybrid mismatch could potentially arise where an Australian entity invests into a foreign jurisdiction through a foreign entity that is treated as a trust for Australian tax purposes, but a company for foreign tax purposes. This is because the payment made by the foreign entity may be treated as a deduction in calculating both the taxable income of the foreign entity in the foreign jurisdiction and the net income of the foreign trust for Australian tax purposes (which is taken into account in the Australian tax base of the Australian beneficiary, being the liable entity in respect of the income of the foreign trust). However, the mismatch amount could be reduced by the foreign entity's dual inclusion income. Entities must be careful when considering what amount would be considered as 'dual inclusion income' as the rules may specifically exclude an amount from this definition (e.g. where a foreign income tax offset is available in Australia for the foreign tax paid in relation to an amount which would have otherwise been considered as 'dual inclusion income').

Deferral of accruals deductions

As a result of the definition of the D/NI mismatch, inbound entities which fund their Australian subsidiaries using a debt instrument which gives rise to an accruals deduction in Australia but defers the recognition of income until payment of the coupon (e.g. Redeemable Preference Shares) are expected to be captured under the proposed rules, unless the instrument has a term of three years or less.

Under the current Australian tax law, Australian borrowers may be entitled to claim interest incurred on offshore debt on an accruals basis under the Taxation of Financial Arrangement rules, even though the interest is not included in the foreign lender's assessable income in the foreign jurisdiction until it is paid. Under the proposed hybrid mismatch rules, these Australian entities may have their deductions deferred where the interest is not included in working out the lender's taxable income in its country of residence within 12 months after the end of the income year in which the accrual deduction is claimed in Australia. The deduction is effectively deferred until a later income year when such amount is subject to tax in the lender's country.

Withholding tax on non-deductible interest

Under the proposed rules, Australian interest withholding tax will continue to be payable even in circumstances where the hybrid mismatch rules permanently disallow (rather than defer) deductions on interest payments made by an Australian entity. 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 transfer pricing rules are unlikely to provide any protection

It is important for taxpayers to note that there can still be a denial of Australian deductions on payments that give rise to a hybrid mismatch outcome despite the transfer pricing rules being satisfied in respect of those payments.

Entities with concessional tax treatment

The hybrid financial instrument mismatch rule is extended so that it also applies to payments that are subject to concessional tax rates in the recipient's foreign tax jurisdiction (i.e. the applicable tax rate is lower than the ordinary tax rate that applies to interest income in that jurisdiction). It is not clear whether the words 'entity of that kind' refer to an entity of the same legal form (e.g. trust, company, partnership) or an entity that is subject to similar tax treatment (e.g. pension fund, REITs).

However, based on the commentaries in the draft explanatory materials, the mere fact that an entity has a concessional tax treatment should not necessarily attract the application of the hybrid financial instrument mismatch rule. This is because in determining whether there is a hybrid financial instrument mismatch, the taxable status of the entities involved should be disregarded. As such, the hybrid financial instrument mismatch rule should not apply where the mismatch is solely attributable to the tax exempt or concessional tax status of an entity in a particular country (e.g. foreign entities that are subject to concessional tax rate, exempt pension fund, etc.) rather than as a result of the differences in the treatment of the particular financial instrument.

Zero tax rate jurisdictions

In determining whether there is a D/NI mismatch, the draft rules are concerned with whether an amount has been included in the tax base of the recipient, and therefore accounted for in working out the tax payable in the foreign jurisdiction. This suggests that to the extent the respective foreign jurisdiction has a corporate tax system and an amount of income or profits is taken into account in calculating the foreign tax payable, the amount is considered to be 'subject to foreign income tax' and therefore does not give rise to a D/NI mismatch even if the rate of tax applicable in the foreign jurisdiction is 0 per cent (e.g. British Virgin Islands).

On the other hand, in determining whether there is a D/D mismatch, the draft rules require the deducted amount to reduce the amount of tax payable by the entity. Based on this definition, it would appear that if a deduction arises in a jurisdiction that has a tax system but imposes a 0 per cent tax rate, no amount could be said to be deducted in working out the tax base of the entity in that jurisdiction as it does not reduce the tax payable by the entity in that country. As a result, a deducting hybrid mismatch would seem to not exist where one of the double deductions arises in a zero tax rate country.

However, it is unclear whether these outcomes are intended. It is unfortunate that the detail of this critical rule has not been included in the exposure draft legislation.

Whilst the draft legislation does not specifically address this aspect, the media release of the Treasurer of the Commonwealth of Australia on the draft rules includes the following, suggesting that the above outcomes may not be within the policy of the rules and are likely to be corrected in the final rules:

> *'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.'*

Interactions with the Controlled Foreign Company (CFC) rules

As currently drafted, the proposed hybrid mismatch rules would appear to also apply when determining the attributable income of a CFC for Australian income tax purposes. However, it is not clear if this is intended.

The takeaway

In almost all cases, simply allowing the hybrid mismatch rules to apply to existing arrangements will not be a viable option for various reasons. We recommend that all Australian taxpayers with cross-border

transactions consider the potential impact of the hybrid mismatch rules and their options, which is likely to involve restructuring to comply with the rules in order to remove adverse outcomes. The potential impact on the Australian real estate and infrastructure market is of particular interest as structures are often foreign debt funded and the use of trusts may, in certain circumstances, give rise to deductions in two jurisdictions.

The proposed law would also require the tax function of Australian inbound and outbound entities to have a level of understanding of the tax treatments of certain payments and/or entities in the offshore jurisdictions which the relevant inbound or outbound group operates. The introduction of the imported hybrid mismatch rule will add an extra layer of complexity to this.

Although not included in the current exposure draft, the Government has 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 (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.

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.

Let's talk

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

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