Hybrid mismatch and low tax lender rules for financial services groups – start preparing now

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In brief

On 24 May 2018, the Government introduced legislation into Parliament which contains Australia's proposed 'hybrid mismatch' rules. These rules are designed to counteract the benefits obtained by exploiting certain differences in the tax treatment of entities, instruments or branches across two or more tax jurisdictions.

The potential impact of the new 'hybrid mismatch' rules for financial services groups – as for all multinationals – should not be underestimated. This is particularly the case given the broad scope of the rules, which include a unilateral integrity measure that was not part of the Organisation for Economic Co-operation and Development's (OECD) recommendations and further measures that go as far as denying deductions for payments in respect of hybrid arrangements that exist completely offshore. In addition, where interest deductions are denied to an Australian taxpayer under the new rules, this does not stop withholding tax being applied, nor allow the relevant arrangement to be removed from thin capitalisation calculations. Accordingly, the costs of the measures applying may be very high.

For financial services groups, not every category of mismatch will be relevant to existing structures. However, it will be necessary to give particular consideration to inbound investments through territorial or low rate jurisdictions, the use of hybrid financial instruments, branch mismatches (including a special rule applicable to Australian branches of foreign banks) and imported hybrid mismatches. There is a clear expectation that affected groups will carefully assess the extent of their exposure and act to remove the hybrid outcome where necessary. This will likely require a significant investment of time and resources, with the Explanatory Memorandum acknowledging the likely compliance costs.

As currently drafted, there is limited transitional relief, there are no de-minimis carve outs, the rules operate on a self-assessment basis and they do not generally rely on the existence of a tax avoidance purpose (the integrity rule being a notable exception).

Working out the likely impact of the new rules will require some effort, particularly for inbound groups where there may be limited awareness of upstream structures and financing. This is exacerbated by the complexity of the rules, the short period of time until they become effective (as early as 1 January 2019 for December balancers) and the need to understand the foreign taxation treatment of relevant entities. For these reasons, it is important to begin planning early, ensure appropriate 'buy-in' from key stakeholders and commence gathering necessary information from offshore.

This TaxTalk Alert considers the likely risk areas for both inbound and outbound financial services groups and isolates a range of matters for consideration prior to implementation.

In detail

Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 (the Bill), currently before Federal Parliament, follows the Government's previous commitment to introduce 'hybrid mismatch' rules consistent with those recommended by the OECD as part its Action 2 response to the Base Erosion and Profit Shifting (BEPS) project.

At their broadest, the rules are directed towards preventing deduction / non-inclusion (D/NI) or double deduction (DD) outcomes arising from the differential treatment of entities, instruments or branches across two or more tax systems.

The Bill sets out six main categories of hybrid mismatches in proposed Division 832 of the *Income Tax Assessment Act 1997*, as well as the following specific measures:

a) the integrity rule to apply to 'financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax' (Foreign Interposed Zero or Low Rate (FIZLR) integrity rule)

b) amendments to Part IIIB of the *Income Tax Assessment Act 1936* (in respect of foreign banks)

c) changes to outbound taxation rules, e.g. restrictions to the foreign branch profits exemption and the exemption for dividends from non-portfolio interests in foreign companies, and

d) preventing the franking of instruments whose coupons are deductible offshore.

For those who have been following Australia's adoption of anti-hybrid rules over recent months, notable differences between the last Exposure Draft (released in March 2018) and the Bill that is now before Parliament include:

- Altering the general commencement date so that the rules generally apply for income years commencing on or after 1 January 2019 (rather than to payments made on or after that date).
- Delaying the start date - to income years commencing on or after 1 January 2020 - for those forms of imported hybrid mismatches which do not arise under a 'structured arrangement'.
- New rules to ensure that deductions denied under the 'hybrid mismatch' rules cannot form part of the tax cost of an asset for capital gains tax or trading stock purposes.
- A directive to ignore voting rights when testing participation interests under the 'Division 832 control group' concept.
- An exemption from the denial rule in Part IIIB where the foreign bank uses a 'recognised transfer pricing methodology' in allocating income and expenses among all of its branches.
- Extending the ability to elect out of Part IIIB to banks which are not resident in a country that has a tax treaty with Australia.
- Rules to clarify how the proposed measures interact with the Taxation of Financial Arrangements and Thin Capitalisation regimes, and an ordering rule which ensures that the six primary forms of hybrid mismatch override the FIZLR integrity rule.
- Amending the FIZLR integrity rule to build in a 'principal purpose test' as a key gateway requirement and remove the interposed entity 'same country' exclusion.

As inbound and outbound multinational groups are likely to be impacted by the proposed rules in different ways, it will be important to perform an initial 'risk diagnosis' in each circumstance. To assist, below are some of the risk areas that are likely to be relevant in practice.

It is important to note that, in most cases, there will be a 'primary response country' and a 'secondary response country'. This TaxTalk Alert is primarily focused on the primary response situations, as that is where deductions are likely to be denied to Australian taxpayers. The need for secondary responses – usually involving the inclusion of amounts in assessable income - will depend largely on the foreign tax treatment of the arrangement, including if, or when, the foreign country implements its own 'hybrid mismatch' rules. They are therefore harder to identify.

To assess the likelihood of the secondary responses being relevant to your structure, it may be worthwhile considering the status of 'hybrid mismatch' rules in the jurisdictions of key related parties (for inbound businesses, this may be the rules in the country where the head office or regional headquarters is located, and for outbound businesses, this may be where branches or key subsidiaries are located). Furthermore, the fact that Australia is a relatively early mover in implementing the full OECD package means that secondary responses may be relevant – at least for an initial period of time.

For a number of the hybrid mismatch categories, there are two key questions to consider:

a) whether the relevant entities are members of the same 'Division 832 control group' (or 'related persons' in the case of hybrid financial instrument mismatches); and
b) whether the arrangement is a 'structured arrangement' being, broadly, one that has the hybrid outcomes priced into it or was designed to secure a hybrid outcome.

If either is answered in the negative, this will often be the easiest 'exit' out of the proposed rules for many arrangements.

Another way of obtaining relief for certain types of mismatches is to identify so called 'dual inclusion income' (DII), being an amount of income or profits that is effectively double taxed – once in Australia and once offshore. In such cases, the rules acknowledge that the D/D or D/NI advantage is reduced to the extent of the DII amounts. It is important to note however, that the DII concept is complex and somewhat difficult to apply in practice.

Before restructuring arrangements in response to the 'hybrid mismatch' rules, it will be important to carefully consider the risk of any anti-avoidance provisions applying. Unfortunately, there is very limited commentary on this issue in the Explanatory Memorandum (EM) to the Bill, and so it will be important to both review any guidance that is prepared by the Australian Taxation Office (ATO) and consider your ATO engagement approach on this issue. This is one of the areas of greatest risk and uncertainty in connection with the new rules.

For completeness, it does not appear that income recognised and taxed at the concessional 10 per cent tax rate offered through Australia's Offshore Banking Unit (OBU) regime will give rise to exposures for the recipient under the proposed rules. However, this may not be the case for the payer, depending on the nature of the hybrid rules (if any) in effect in its home jurisdiction.

Expected risk areas for inbound financial services groups

In general, the complexity and risks for inbound financial services groups appear to be greater than those for outbound financial services groups. Some of the key risk areas are outlined below.

Inbound branch mismatch – intra-entity payments

Proposed amendments to Part IIIB of the *Income Tax Assessment Act 1936* can operate to deny deductions that are otherwise allowable in respect of notional interest and notional derivative payments made to any other part of the bank.

In this case, there is no requirement for the arrangement to occur within the same 'Division 832 control group', or that it be part of a 'structured arrangement'. However, under an amendment reflected in the Bill, the rule is disabled where '*... the foreign bank adopts a recognised transfer pricing methodology in allocating expenditure and income between itself and all its branches*'. The EM provides no further

guidance on the intended meaning of this phrase. It will therefore be important to assess any guidance that is released by the ATO in relation to this particular issue. Moreover, it is unlikely that having robust transfer pricing documentation will automatically attract the operation of the exemption and, given its significance, it is reasonable to expect greater scrutiny of the pricing or attribution methods used for intra-bank transactions than in the past.

The following questions arise in considering how the transfer pricing 'safe harbour' exemption might apply in practice, and demonstrate that the assessment arguably goes beyond determining whether the 'right' transfer pricing outcome is being achieved:

- Is 'a recognised transfer pricing methodology' a reference to Subdivision 815-B of the *Income Tax Assessment Act 1997*, given that those rules are taken to apply to transactions recognised under Part IIIB?
- If so, does that mean that any bank which prices its internal dealings as if they were transactions with separate entities and consistently with the OECD Transfer Pricing Guidelines (using one of the supported pricing methods) will be able to access the exemption?
- Does the reference to 'allocating expenditure and income' mean that the bank must still be able to demonstrate that the internal dealings represent an allocation of the effects of third party transactions for the purposes of the exemption, even though Part IIIB deems the transaction to exist for all income tax purposes without the need for such tracing?
- If Subdivision 815-B of the *Income Tax Assessment Act 1997* is not relevant, can a bank apply the 'Authorised OECD Approach', despite the fact that Australia has rejected any reliance on this method (given the separate entity approach conflicts with case law)?

We will be raising these issues with the ATO for consideration as it looks to develop guidance in relation to the hybrid mismatch rules.

Where the transfer pricing 'safe harbour' exemption is not available, it will be necessary to ascertain whether the bank has an exposure under the primary measure. This rule commences by denying the entire notional payment in question, but then reduces the denial to the extent of the following amounts:

- *Dual inclusion income*. Where the residence jurisdiction of the foreign bank has a worldwide system of taxation (or has an exemption regime which does not fully exempt branch profits), the inclusion of branch income or profits in the foreign tax base should result in DII being available to 'neutralise' the mismatch. However, the bank must remain within Part IIIB in future years if DII earned in such a year is to refresh the deduction initially denied under the main rule. Helpfully, DII can still arise where the amount included under foreign law is gross income and where the foreign jurisdiction allows a credit for the tax payable in Australia.
- *Non-deductible expenses*. Where the residence jurisdiction has an exemption system, it will be necessary to work out whether some or all of the internal interest or derivative expense effectively matches payments made to third parties that are denied deductibility due to their nexus in deriving exempt branch profits (or because the foreign country has limited its branch profits exemption under its own 'hybrid mismatch' rules). If so, the deductibility of the internal payment in Australia is preserved. This will be difficult to apply in practice because, although the rules do not seem to require strict one-for-one tracing, they require it to be 'reasonable to conclude' that the notional borrowing is effectively funded by actual borrowings (or, in the case of derivatives, that the external transaction hedges or manages the risk on the internal transaction). The EM provides little guidance on when it is 'reasonable to conclude' that this is the case. Complications arise in relation to pool funding, macro-hedging of derivatives, foreign thin capitalisation regimes and differential debt/equity splits between branch versus head office.

- *Internal payment is taxed.* In certain instances, the foreign jurisdiction may apply tax to the notional payment. This could occur where the foreign jurisdiction has adopted the OECD branch mismatch rules (as assessing internal payments is one method for curtailing the scope of the branch profits exemption) or the foreign jurisdiction applies the 'functionally separate enterprise' approach (authorised OECD approach) when it comes to the taxation of branches. In either case, the relevant portion of the internal payment that is subjected to tax should remain deductible.

Where the rule is triggered in relation to an amount of notional interest, it appears to apply to the amount determined after application of the London Inter-bank Offered Rate (LIBOR) cap. However, even if some or all of the resulting notional payment is denied, it will continue to be subject to the five per cent withholding tax that applies under Part IIIB. Note also that where a deduction is denied under this provision in respect of an internal derivative, there is no symmetry to also treat any income as non-assessable (this would be important, for example, for fair valued derivatives where the value may be subject to volatility).

Importantly, taxpayers who elect out of Part IIIB will be able to deactivate this rule. We expect that the new denial rule, along with the negative impact of the LIBOR cap, may drive many foreign banks and financial entities to do exactly that going forward. Of course, this necessitates a wider cost/benefit analysis which takes into account other factors, such as whether the entity wishes to transfer losses to or from a related subsidiary.

Pleasingly, an amendment contained in the Bill will extend this election to banks which are resident in a jurisdiction that does not have a relevant tax treaty with Australia. Accordingly, all banks and other financial entities subject to the rules in Part IIIB should now be able to elect out of the regime on an annual basis, and thereby escape the operation of this new rule.

Deducting hybrid mismatch - duplicated branch deductions

Payments made by a local branch of a foreign company to a third party can be denied deductibility where they generate a D/D outcome, i.e. a deduction in both Australia and the foreign jurisdiction. This is referred to as a 'deducting hybrid mismatch'. For the purposes of this particular category, the term 'payment' is broad in its meaning and is extended to cover depreciation deductions and net losses from interests in trusts or partnerships.

A D/D outcome is more likely to arise where the residence jurisdiction has a worldwide tax system. This is because exemption regimes generally deny deductions referable to exempt branch profits. However, at the same time, this may make it more likely that the entity will have DII that is available to neutralise any potential denials.

Deductions for such payments should only be denied under the hybrid mismatch rules where:

- The foreign country does not have rules which are the same, or have substantially the same effect, as Australia's 'hybrid mismatch' rules (as in that case, it is assumed that the primary response country's rules are inadequate and Australia should execute a secondary response); and
- The 'Division 832 control group' or 'structured arrangement' limb is met.

As many countries are implementing 'hybrid mismatch' rules later than Australia, e.g. the EU in 2020, or rules which differ from the OECD standard on which Australia's rules are based, the first limb will often be met – at least for an initial period of time. For example, it is not entirely clear just how closely a foreign jurisdiction's rules will need to align with Division 832 for those rules to be seen as a law that has 'substantially the same effect as' Australia's regime. The question about whether this test should be applied across the entire set of rules or only in relation to the particular category in question needs to be considered. This becomes a live issue when one considers jurisdictions such as the United States, which has implemented some limited 'hybrid mismatch' rules that deviate from the full OECD framework.

Any exposure will then turn on whether the second limb is satisfied. In this regard, the 'Division 832 control group' test is drafted in way that makes it self-fulfilling in the case of a branch / head office arrangement.

Accordingly, careful analysis of how such payments are treated at both the branch and head office levels will be needed (along with an assessment of whether the foreign jurisdiction has equivalent 'hybrid mismatch' rules), in testing whether a business is exposed under this particular type of mismatch.

The integrity rule (otherwise known as FIZLR)

The FIZLR integrity rule will deny deductions for interest and certain derivative payments made by an Australian taxpayer to an interposed foreign entity (IFE) where:

- Another foreign entity (whether or not resident in the same jurisdiction as the IFE) is the ultimate parent entity of a 'Division 832 control group' containing all three (or more) entities;
- The payment is either not taxed in any foreign country, or is taxed in one or more foreign countries but the highest rate of tax levied is 10 per cent or less;
- The payment is not subject to Australian tax; and
- It is reasonable to conclude, having regard to certain stipulated matters, that one of the entities that entered into or carried out the scheme had a principal purpose of both enabling the deduction and enabling foreign tax to be levied at a rate of 10 per cent or less.

Importantly, the rules do not require the IFE to on-pay the amount to the ultimate parent entity and there is no 'structured arrangement' limb. The rule is also extended to payments through local interposed trusts or partnerships.

For loan arrangements, there is also a back-to-back rule which can apply where the first offshore entity is subject to 'high tax' and is interposed between the Australian payer and a third entity subject to 'low tax', i.e. to prevent the interposition of a conduit entity in a 'high tax' country to circumvent this measure. There is no requirement for the interposed entity to be related to the Australian payer, which will make this measure difficult to apply in practice. Therefore, financing advanced to Australia should be closely examined even if the immediate counterparty is in a 'high tax' jurisdiction. Cash pooling arrangements should also be considered carefully because they may qualify as back-to-back arrangements in some circumstances. There are many aspects of the operation of this back-to-back rule which are unclear and are likely to lead to uncertainty in many cases.

The inclusion of the 'principal purpose test' (PPT) as a gateway provision was a key change made in finalising the measures as compared to the last Exposure Draft law. Unlike similar tests elsewhere in the tax law, the PPT only requires regard to be had to the following three specified factors:

a) the facts and circumstances that exist in relation to the scheme

b) for loans only, the source of the funds used by the IFE, and

c) whether the IFE is engaged in substantial banking, financial or other similar business.

As is always the case with such purpose-based tests, whether the requirement is satisfied will be highly dependent on the facts. However, the EM includes a number of examples which suggest that:

- The rule should not be triggered where the low rate of foreign tax suffered is only due to the availability of foreign tax credits offshore.
- The PPT should not be triggered in a case where the loan is made in the ordinary course of a financing business carried on by a regional/global finance company that makes loans using a range of funding sources (including parent equity).
- The use of equity funding from the ultimate parent of the interposed foreign entity, especially if it operates to convert otherwise taxable interest into exempt dividends, will likely be influential in deciding whether the PPT applies.

There are two primary exclusions from the operation of the FIZLR rule:

- Where it is reasonable to conclude that a controlled foreign company (CFC) regime in Australia or offshore will attribute and tax the relevant payment. The Bill requires 100 per cent of the attributable income of the CFC to be attributed to Australian residents (or foreign residents where foreign CFC regime applies), and

- Where it is reasonable to conclude that the payment would have been similarly 'low taxed' if paid directly to the ultimate parent entity (and would not have given rise to certain forms of mismatch). This is unlikely to be relevant in practice, as few inbound groups will have parent entities in countries with tax rates of 10 per cent or less.

- Although payments to 'no tax' countries are clearly in the frame, a key risk area to consider will be payments made to 'territorial regimes' such as Hong Kong or Singapore.

- Of the various measures covered by the new law, this category is likely to be the most problematic – both in terms of its scope and in how it can be sensibly applied in practice. As a unilateral measure not supported by the OECD, the BEPS materials provide no assistance in understanding the operation of the FIZLR.

Imported hybrid mismatches

Another difficult area is that of 'imported hybrid mismatches'.

Under this category, an Australian taxpayer may be denied a deduction for any deductible payments made, directly or indirectly, to an offshore structure that generates a hybrid mismatch as between two foreign countries. This includes any arrangement falling within any of the six main hybrid mismatch categories. For example, this rule could affect the payment of interest on a loan from an offshore finance company that acts as a central borrowing vehicle for the global group and issues hybrid instruments that generate a D/NI outcome offshore.

Although the 'Division 832 control group' or 'structured arrangement' limbs must still be satisfied before this rule will be engaged, it will be quite difficult in practice to obtain enough information on the upstream arrangements to confidently assess whether or not there is an imported hybrid mismatch.

Moreover, if this category of mismatch applies, there are complex priority rules designed to pro-rata the deductions based on the extent of the hybrid mismatch that exists offshore, and further rules requiring the carry forward of amounts where the offshore mismatch is only partly neutralised in a given income year.

One key change between the recent Exposure Draft and the Bill was a deferral of the commencement date (to years commencing on or after 1 January 2020) for those types of imported hybrid mismatches which do not occur under a 'structured arrangement'. This broadly aligns with the proposed timing of the EU hybrid mismatch rules and provides some additional time for taxpayers to assess whether these types of mismatches may be relevant. However, in the meantime, taxpayers will need to identify imported hybrid mismatches and decide if they qualify as structured arrangements.

Other potential risks

Other potential risk areas include:

- *Leasing transactions.* It is possible for depreciation claims on leased assets to generate deductions in two different jurisdictions where disregarded entities or branches are involved (a D/D outcome). Where this occurs, it can attract the 'deducting hybrid mismatch' rules. Alternatively, the differential classification of a lease as an operating lease in one country and a finance lease in another can generate D/NI outcomes that result in a 'hybrid financial instrument mismatch'. However, in each case, it would be necessary for the transaction to occur within the same 'Division 832 control group' or to satisfy the 'structured arrangement' limb.

- *Securities lending transactions and repurchase agreements*. Manufactured payments on such transactions may give rise to D/NI outcomes and a 'hybrid financial instrument mismatch' in certain specific circumstances. However, this would need to occur under a 'structured arrangement' or as between 'related persons'.

Expected risk areas for outbound financial services groups

The risks for outbound groups appear to be less acute because, once any relevant foreign jurisdictions have implemented the 'hybrid mismatch' rules in their own law (which in some cases may be years away), it will generally be those foreign countries that are expected to take the lead in reversing DD or D/NI outcomes.

The key focus areas for outbound groups are likely to be as follows:

- *Deductible / frankable instruments*. Most Australian authorised deposit-taking institutions (ADIs) and insurers will be well aware of the proposed rule which will prevent franking credits from being attached to instruments whose distributions are deductible in a foreign jurisdiction. However, we note a slight change to the grandfathering rule in the final Bill. It will now operate to ignore a call date following 9 May 2017 under an instrument that qualifies as Additional Tier 1 Capital where APRA has prevented the issuer from exercising the relevant call right.
- *Outbound branch mismatches*. Proposed amendments to the foreign branch profits exemption (section 23AH of the *Income Tax Assessment Act 1936*) are designed to remove the exempt treatment of branch profits to the extent that a payment made to the Australian company is deductible to the relevant payer and either the payer is part of the same 'control group' or the payment occurs under a 'structured arrangement' (bringing about a D/NI outcome and a 'branch hybrid mismatch').
- *Deducting hybrid mismatches*. Australian deductions may be denied under a primary response rule where some or all of a payment made by an Australian resident entity is also allocated to a foreign branch and allowed as a deduction for the purposes of the domestic law in the country where the branch is located. The potential application of this rule will be highly dependent upon the facts as well as the operation of the domestic law where the foreign branch is located.

The takeaway

The time for action is now. It is likely that the 'hybrid mismatch' rules will complete their passage through Parliament relatively quickly in the current Winter sittings, and potentially could be enacted before financial year end.

If that timing is achieved and your organisation has a 30 June year end for accounting purposes, you may need to consider the impact of the rules on your forthcoming financial accounts.

Moreover, with new rules applying as early as 1 January 2019 for some taxpayers, the window to undertake any restructuring is particularly narrow. Although the ATO has acknowledged that many taxpayers will need to restructure or refinance, little guidance has been provided on the tax risks associated with such restructuring.

If you have not already started preparing, we recommend developing a two-step strategy that diagnoses potential risks and then assesses the feasibility of carrying out any restructuring before the expected start date. The financial impacts of 'doing nothing' are likely to be considerable – as deductions may be denied, but withholding tax and thin capitalisation impacts will remain.

PwC has been involved in the consultation process surrounding the development of the Bill and in assisting clients to identify the potential impact from the proposed rules (including by leveraging our global network). We are well placed to assist you in tackling this task.

Let's talk

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

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