Hybrid mismatch rules: tweaks and uncertainties

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In brief

On 13 December 2019, Australian Treasury released *Exposure Draft legislation* which proposes to make a number of "tweaks" to the Australian hybrid mismatch rules which were enacted in August 2018. Public consultation on these proposed amendments closed on 24 January 2020 and PwC made a submission in relation to this draft legislation including other elements of the existing law which are generating uncertainties for a range of taxpayers.

As we enter the tax return preparation period for those taxpayers with a 31 December year end who are first affected by the hybrid mismatch rules, we highlight some of the recent developments and practical experiences in relation to these rules. Taxpayers also need to be comfortable whether any potentially adverse impacts that arise from these rules should be reflected in their 31 December financial statements.

In detail

The Australian hybrid mismatch rules were released in draft form in late 2017, legislated in August 2018 and took effect for tax periods commencing on or after 1 January 2019.

In practice, our experience has been that many taxpayers are finding it challenging to interpret and apply this complex and novel legislation. A key element of difficulty continues to be the requirement under the hybrid mismatch rules to make judgements about the operation of foreign tax laws as well as the presumption that the Australian taxpayer has perfect knowledge of the overseas group structure, relevant foreign law and the flow of payments through the group structure which arise from deductions in Australia. These difficulties are evident from *draft guidance* released by the Australian Taxation Office (ATO) in relation to the United States (US) global intangible low-taxed income (GILTI) rules which, in essence, include certain income of controlled foreign companies in the US tax base. PwC provided a submission to the ATO on 16 January 2019 in relation to this draft guidance.

The ATO has also publicly indicated that the following issues have been the subject of detailed consideration and will most likely be the subject of ATO guidance:

- whether the US has tax laws which correspond to, or have substantially the same effect as, the Australian hybrid mismatch rules. This takes into consideration the combined effect of US tax laws including its anti-hybrid rules (s267A), dual consolidated loss rules (s1503) and treatment of hybrid dividends (s245A(e)); and
- how intra-group payments between members of a US tax consolidated group should be treated, in particular, whether the payments are disregarded for the purposes of the Australian hybrid mismatch rules or treated as offsetting deductions and income inclusions.

The ATO has indicated that the outcome of these views has precedential and significant impact for inbound US multinational companies.

Another common difficulty is the broad scope of the imported mismatch rules which can impact any related-party cross border payments that are deductible for Australian income tax purposes. For example, this rule can affect deductions for the cost of goods sold as well as interest, royalties and management fees.

In addition, Australia's hybrid mismatch rules include a *low tax lender rule* which is designed to prevent the use of interposed conduit type entities that effectively pay no (or 'low') tax to fund investments in Australia. This rule has taken some taxpayers by surprise principally because it is a key departure from the recommendations of the Organisation for Economic Co-operation and Development (OECD) in relation to hybrid mismatch arrangements.

The first tax returns affected by these rules are those for the tax year ended 31 December 2019 and these are due to be lodged in July 2020. Judgements will need to be made by taxpayers in relation to the myriad of uncertainties in relation to the hybrid mismatch rules including those highlighted above, most probably before any further public guidance from the ATO and quite likely before proposed changes noted below have been legislated. The tax return will require *extensive disclosure* in relation to the potential operation of the hybrid mismatch rules including restructuring designed to remove hybridity.

It remains to be seen what support the ATO may expect from taxpayers in relation to positions adopted in tax returns. For example, it is not clear what level of due diligence will be expected to conclude that a multinational does not have any offshore hybrid mismatches which may activate the imported mismatch rules.

On 13 December 2019, Treasury released *draft legislation* in relation to the Federal Government's 2019-20 Budget announcement to make a number of technical amendments to the hybrid mismatch rules. Specifically, the draft legislation seeks amendments designed to:

- ensure that the rules apply to multiple entry consolidated (MEC) groups in the same way as tax consolidated groups,
- clarify that the definition of 'foreign income tax' does not include foreign municipal or State taxes,
- clarify the operation of the rules for trusts and partnerships,
- ensure that the unilateral low tax lender rule can apply where other hybrid mismatch provisions have applied and will apply to payments by subsidiaries (not just the head company) of tax consolidated groups,
- clarify the operation of the dual inclusion income on-payment rule, and
- allow franking benefits on distributions made on Additional Tier 1 capital instruments in certain circumstances.

The proposed amendments, once enacted, are generally intended to apply to assessments made for income years starting on or after 1 January 2019 (i.e. retrospectively from the time that the hybrid mismatch rules started to apply) but some of the proposed amendments are intended to apply to assessments made for income years starting on or after 2 April 2019 (i.e. date of the Government announcement).

PwC has made a submission in relation to this draft legislation and also suggested consideration be given to clarifying aspects of the law relating to interactions with foreign laws.

The takeaway

All taxpayers with any related-party cross border deductible payments (or hybrid entities, including Australian entities that may be 'disregarded' for foreign tax purposes) should be reviewing the potential impact of the hybrid mismatch rules including the imported mismatch and low tax lender rules. As the hybrid mismatch rules do not have a tax avoidance purpose test, a de minimis carve out or transitional provisions, in practice we have found that many taxpayers with cross border transactions could be caught off guard.

This will be important for the purposes of year end tax provisioning for accounting purposes as well responding to extensive questions on the annual Australian income tax return.

Let's talk

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

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