Hybrid mismatch and low tax rate lender rules introduced into Parliament

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In brief

On 24 May 2018, legislation was introduced into Federal Parliament to give effect to the Organisation for Economic Co-operation and Development's (OECD) recommended hybrid mismatch rules, as originally announced by the Australian Government 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 neutralised by disallowing a deduction or including an amount in assessable income.

The measures broadly apply in the same manner as the exposure draft law released on 7 March 2018, which was an update to the incomplete draft law previously released for comment on 24 November 2017. However, there have been some changes following public consultation. For further background on these exposure drafts, refer to our TaxTalk Alerts published on 9 March 2018 and 27 November 2017 respectively.

The legislation includes a more refined 'integrity rule' designed to prevent multinational groups from using interposed conduit type entities that effectively pay no tax to invest in Australia, as an alternative to investing into Australia using hybrid entities or instruments. The integrity rule is a unilateral measure, first announced by the Treasurer in November 2017, and is a key departure from OECD recommendations in relation to hybrid mismatch arrangements.

The legislation will generally apply to income years starting on or after 1 January 2019. Restrictions on the foreign dividend participation exemption will apply to distributions made on or after 1 January 2019. However, the imported mismatch rule (other than for structured arrangements) will apply to income years starting on or after 1 January 2020.

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 (BoT) to consult on the implementation of hybrid mismatch rules developed by the 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, along with the BoT recommendations accepted by the Government, the hybrid mismatch rules were originally intended to apply to all payments made on or after the later of 1 January 2018 or six months after the relevant law was enacted. The start date of the measures is now certain under the legislation that is currently before Parliament.

Following additional consultation conducted by the BoT, the Australian Government 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. Some of these recommendations have been incorporated into the legislation.

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. The United States has introduced limited hybrid mismatch rules applicable from 1 January 2018. New Zealand has introduced legislation into Parliament which includes OECD-style hybrid mismatch rules applicable from 1 July 2018. Twenty eight EU member states plan to introduce hybrid mismatch rules from 1 January 2020.

In detail

The Bill, *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018* (including 96 pages of law and 133 pages of explanatory material), which seeks to implement the hybrid mismatch rules into Australia, generally incorporates the key elements of the last exposure draft material released in March 2018, with some welcome changes and clarifications. We note that these measures are broadly consistent with the OECD recommendations, but there are some departures which will be important to understand. The rules are complex and require an enquiry into the operation of foreign tax rules.

The legislation is expected to have 'an unquantifiable gain to revenue over the forward estimates period'. It is recognised that the legislation will impose compliance costs as taxpayers will be required to obtain sufficient information to identify and assess the expected tax treatment of instruments or entities in a foreign counterparty jurisdiction. However, the Government concludes that 'in most cases parties to a cross border arrangement would be aware of, or be able to obtain information about, the counterparty tax treatment'.

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 and, in some cases, amounts representing a decline in the value of an asset) 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 an arrangement gives 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. The purpose of the arrangement, generally, should not affect the outcome.

For example, a tax deduction could be denied in Australia for royalties or interest 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 a hybrid entity. This denial would apply despite the Australian taxpayer satisfying other

rules (e.g. transfer pricing and thin capitalisation) 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 the dividends paid to Australia.

In addition, the legislation includes imported hybrid mismatch rules which, in essence, seek to reduce or eliminate tax deductions for payments made by an Australian entity 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, the purchase of trading stock and fees for services.

Imputation benefits may 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 or insurance company that was issued before 9 May 2017.

The legislation also addresses branch mismatch arrangements. The proposed measures will:

- Limit the foreign branch exemption (i.e. section 23AH of the Income Tax Assessment Act 1936) in respect of branch hybrid mismatches. In broad terms, a branch hybrid mismatch arises where the residence country provides a branch exemption, but the branch country does not tax the payment because the payment is treated as not derived in carrying on business through a permanent establishment.
- Disallow a tax deduction for payments that give rise to a branch hybrid mismatch for the payee.
- Disallow tax deductions for interest in respect of notional borrowings and payments in respect of notional derivative transactions for Australian branches of foreign banks that have not chosen to opt out of the deeming rules in Part IIIB of the Income Tax Assessment Act 1936 (this election to opt out will be extended by the legislation to foreign banks resident in non-treaty countries). In addition, a safe harbour is provided by the legislation if the foreign bank adopts a recognised transfer pricing methodology in allocating income and expenditures between itself and all of its branches.

Unlike other recently enacted international tax measures in Australia, which are predominantly aimed at ‘significant global entities’ (SGEs) that exceed a global annual revenue threshold of AUD1 billion, the hybrid mismatch rules have no de minimis threshold.

Operative date

The legislation will generally apply to assessments for income years starting on or after 1 January 2019, e.g. as early as 1 January 2019 for December balancing taxpayers and 1 July 2019 for June balancing taxpayers. This effective date is now consistent with the OECD recommendation that ‘the rules should generally take effect from the beginning of a taxpayer’s accounting period’.

Imported mismatch payment rules (other than structured arrangements) will generally apply to assessments for income years starting on or after 1 January 2020.

The measures which operate to override the exemption for certain foreign equity distributions (e.g. deductible dividends received by Australian corporate shareholders) will generally apply to distributions made on or after 1 January 2019.

It is highly likely that the legislation will be passed by the Australian Parliament by 28 June 2018 (the last day of the Winter sitting) and therefore comply with the Government’s commitment to provide taxpayers with a minimum period of six months to consider and deal with their existing hybrid arrangements.

New integrity rule

In November 2017 the Australian Government announced an integrity rule that would apply to 'financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax'. This was in spite of the 2015 OECD report which indicated that 'The recommendations in the report … are not intended to capture payments made to a person resident in a no-tax jurisdiction'. In addition, the OECD recognised 'the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations'.

The current law includes the integrity rule to give effect to the Government's announcement, but it has been substantially modified from the draft first released in March 2018. The stated intent is to 'prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed conduit type vehicles to invest into Australia, as an alternative to investing into Australia using hybrid instruments or entities.' According to the Government, this departure from OECD recommendations is justified to '… allow for unique features of the Australian tax system that were not specifically contemplated by the OECD recommendations'. These unique features are not explained.

This new unilateral measure overrides the recommended OECD hybrid mismatch rules and has the potential to impose additional Australian tax on interest and derivative payments to foreign interposed zero or low rate (FIZLR) entities, irrespective of whether the arrangement involves a hybrid element.

This rule operates to deny Australian income tax deductions for payments where all of the following conditions are satisfied:

- an Australian entity makes a deductible payment under a scheme to a foreign entity (the interposed foreign entity) either directly, or indirectly through one or more interposed Australian trusts or partnerships;
- the Australian entity, the interposed foreign entity and another foreign entity (the ultimate parent entity, not controlled by any other entity) are in the same control group;
- the payment is of an amount of interest, or an amount in the nature of interest or an amount under a derivative financial arrangement;
- the payment is not subject to Australian income tax;
- the payment is not subject to foreign income tax, or is subject to foreign income tax in one or more foreign countries, and the highest rate at which the payment is subject to foreign income tax is 10 per cent or less; and
- it is 'reasonable to conclude' (having regard to particular stipulated matters, see below) that participants who entered into or carried out the scheme 'did so for a principal purpose, or for more than one principal purpose that includes a purpose of: (i) enabling a deduction to be obtained in respect of the payment; and (ii) enabling foreign income tax to be imposed on the payment at a rate of 10 per cent or less, or enabling the foreign income tax not to be imposed on the payment'.

In determining 'principal purpose', it is necessary to have regard to the following matters:

- the facts and circumstances that exist in relation to the scheme;
- if the payment is an amount of interest, the source of the funds used by the foreign interposed entity to provide the Australian entity with the loan or other debt interest in respect of which the payment of interest is made (for example, equity funding of the foreign interposed entity might be indicative of a requisite purpose); and
- whether the interposed foreign entity engages in substantial commercial activities in carrying on a banking, financial or other similar business (for example, conducting a function of providing

finance to group members and a loan to the Australian entity consistent with normal business practice might suggest a requisite purpose does not exist).

Deductions will not be denied if it is 'reasonable to conclude' any of the following conditions are satisfied:

- the payment is taken into account under the Australian controlled foreign company (CFC) rules or the law of a foreign country that has 'substantially the same effect' as the Australian CFC rules; or
- assuming that the payment had been made directly to the ultimate parent entity, the payment would be: (i) subject to foreign income tax at a rate that is the same as, or less than, the foreign country rate or not be subject to foreign income tax; and (ii) the payment would not give rise to a hybrid mismatch.

In relation to the foreign CFC exemption, the Explanatory Memorandum indicates that the outcomes under a foreign CFC regime will not be treated as having 'substantially the same effect' as the Australian CFC rules where the amount included is reduced or offset by amounts of a kind not allowable under the Australian CFC rules (such as deductions, losses or other attributes pooled from other group entities). It is expected that this commentary, not included in earlier drafts, may be particularly relevant in analysing the impact of recent US tax reform measures.

The integrity rule also includes a conduit type rule which is applied on a look through basis to payments 'made under an arrangement involving back-to-back loans or an arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans' where certain other conditions are satisfied. In these circumstances, for the purposes of identifying a FIZLR entity, the Australian entity will be treated as having made the payment directly to the foreign entity that is the ultimate recipient in the back-to-back arrangement.

Additionally, the Minister has powers to specify, in the form of a legislative instrument, schemes or circumstances where the integrity rule will not operate to deny a deduction. The purpose of this power is to ensure the integrity rule does not apply to deny deductions in inappropriate circumstances.

Overall, there are some welcome clarifications to the integrity rule. However, a number of uncertainties remain, particularly in relation to thresholds such as 'reasonable to conclude' and 'principal purpose', as well as key undefined terms including 'back-to-back loans', 'substantially the same', 'substantial commercial activities' and 'source of the funds'. Unfortunately, the OECD recommendation and guidance will be of no assistance because this measure is a departure from OECD recommendations.

Restructuring

Based on experience to date, our expectation is that, in almost all cases, simply allowing the hybrid mismatch or integrity 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 or FIZLR entities will need to consider their options, which is likely to involve restructuring to comply with the rules in order to remove adverse outcomes. The OECD report had anticipated that taxpayers would 'restructure existing arrangements to avoid any adverse tax consequences associated with hybridity'.

Restructuring to remove hybridity and FIZLR entities seems to be the clear intent and expectation of the legislation. The Explanatory Memorandum explains that '...many taxpayers will restructure out of hybrid arrangements that would otherwise be subject to the OECD hybrid mismatch rules (including arrangements subject to the integrity rule) and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules'. In addition, it is stated that a restructure that, for example, '... could result in retaining a deduction [in Australia] with a greater amount being included in a foreign income tax base ... would satisfy the objective of the hybrid mismatch rules'.

Similarly, we would expect new financing and refinancings to be designed to ensure the hybrid mismatch and integrity rules are not activated.

The Australian Taxation Office (ATO) has signalled plans to provide rulings and other administrative guidance in relation to this legislation, including a Practical Compliance Guideline regarding 'the application of the anti-avoidance rule in Part IVA to restructures undertaken to existing hybrid mismatch arrangements'. The timing of this guidance has not been announced and remains uncertain.

Other changes

A number of aspects of the rules have been enhanced and clarified from the exposure draft legislation released in March 2018. These include:

- In determining the members of a 'Division 832 control group', participation interests should be calculated without regard to the criteria relating to the rights of shareholders to vote or participate in certain decision-making.
- Clarification of the interaction of the hybrid mismatch rules with various other rules including thin capitalisation, Taxation of Financial Arrangements (TOFA), residence, trading stock valuation and capital gains tax cost base rules.
- Commentary in relation to the circumstance where, in applying the legislation, regard should be given to the OECD commentary (for example, in relation to the definition of structured arrangement).
- The extension of certain transitional rules in respect of regulatory capital to insurance companies.

The takeaway

With the final version of the hybrid mismatch and low tax lender rules expected to become law next month, we recommend that all Australian taxpayers with cross-border transactions consider the potential impact of the hybrid mismatch rules sooner rather than later. This will include the identification of any potential FIZLR entities. From experience in other countries, as well as from the draft rules previously released, identifying potential hybrid mismatches and FIZLR entities is not straightforward in many cases. This is principally because the legislation assumes that the Australian taxpayer has complete and comprehensive knowledge of the group structure and funding arrangements of the entire group.

Once identified, restructuring out of hybrid arrangements and FIZLR entities and into alternative arrangements will be a necessity for many taxpayers. This will require careful consideration of legal (including Foreign Investment Review Board), accounting, treasury, stamp duty and foreign tax issues, and timing will be tight in many cases given the wide range of complexities involved.

Let's talk

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