THE TAX INSTITUTE

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By email: BEPS@treasury.gov.au

Dear William,

Implementing the OECD Hybrid Mismatch Rules

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to the *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2018: Amendments* (**Exposure Draft**) and associated Explanatory Materials (**EM**).

Summary

As this is a second iteration of the Exposure Draft, The Tax Institute seeks only to raise issues of significance in relation to the Exposure Draft, noting The Tax Institute was unable to provide a submission on the first iteration of the Exposure Draft. These issues include:

- Concerns with the extensive scope of the Integrity Rule;
- Impact on structured arrangements;
- Concerns with hybrid financial instrument mismatches;
- Concerns with the branch hybrid mismatch rules; and
- Other matters.

Discussion

1. Division 832-J – Integrity Rule

The Tax Institute has numerous concerns with the Integrity Rule which are set out below.

Firstly, we are concerned the Integrity Rule oversteps the boundaries of where the Australian tax law should apply. We would appreciate obtaining a better understanding of why this has occurred. We are concerned that the Integrity Rule applies too broadly and this may result in driving business away from Australia and therefore eroding the Australian tax base. This is a unilateral Australian initiative which goes beyond the boundaries of the 'common approach' set out in BEPS Action Item 2 *Neutralising the effects of Hybrid Mismatch Arrangements*.

We also note the following:

i) It would be helpful if the purpose of the new integrity measure was set out in Subdivision 832-J and the EM to better articulate the concerns that the provision seeks to address.

ii) The new anti-hybrid rules should also explain how the new integrity measure (Subdivision 832-J) interacts with the imported mismatch rules (Subdivision 832-H). i.e. which takes priority?

Secondly, we have some comments in relation to the exceptions in new section 832-800.

i) In relation to the exception regarding whether the payment the subject of the rules has been subject to another country's corresponding 'controlled foreign company' (**CFC**) rules (section 832-800(3)), we would appreciate further clarification as to a taxpayer should form this conclusion in order to satisfy the Integrity Rule.

   There is no guidance provided in the EM regarding what factors a taxpayer needs to take into account to form this conclusion on a reasonable basis. Paragraph 1.304 of the EM simply restates the proposed law. We suggest that the EM elaborate on the key features of Australia's CFC rules to enable taxpayers to make a reasonable judgement whether a payment has been included under a corresponding provision of a foreign country. It would be useful if this guidance was supplemented by guidance issued by the ATO.

ii) In relation to the exception contained in section 832-800(5), where it is reasonable to conclude that the scheme was not designed to produce certain specified outcomes, the language in the provision is not helpful. For example, we do not believe that it is intended that the mere satisfaction of the specified criteria is sufficient for it to be concluded that the scheme was

‘designed to produce’ the specified outcomes and therefore the exception would apply.

The use of the expression ‘designed to produce’ directs attention to the purpose of the scheme not just the outcome sought to be obtained. In this respect, and given the provision is drafted in the negative, it is not clear whether the relevant design of the scheme is intended to relate to, for example, the sole or dominant purpose of the scheme, a principal purpose of the scheme, an ancillary purpose of the scheme or something else.

It would be useful if more examples could be included in the EM to provide further clarity around this exception. The examples in the EM do not do this sufficiently in our view. If not, it would be useful if relevant examples could be included in an appropriate piece of guidance from the ATO (either a Law Companion Ruling or Practical Compliance Guideline) with representatives from industry working with the ATO on this guidance.

Also, it is unclear what section 832-800(6) does. Is it trying to expand or contract what must be considered when forming a view whether ‘it is reasonable to conclude’ whether a scheme has been designed to produce the effects mentioned in section 832-800(5)? We suggest that further clarification of this provision be provided.

Thirdly, there are practical difficulties with the application of these rules. Given the breadth of the application of the Integrity Rule, it would assist taxpayers to apply these rules if practical guidance was provided by the ATO in relation to how the rules should apply.

2. Hybrid financial instrument mismatches: Structured Arrangements

Broadly, the purpose of Subdivision 832-C is to address hybrid financial instrument mismatches that arise between related parties or between parties to a ‘structured arrangement’ (with a carve out for entities that are not party to a structured arrangement) to ensure that a deduction is denied or there is an inclusion where the mismatch otherwise gives rise to a deduction/non-inclusion.

A payment is made under a structured arrangement where either the hybrid mismatch is priced into the terms of the scheme, or it is reasonable to conclude that the hybrid mismatch is a ‘design feature’ of the scheme (see section 832-210(1)(b)).

We believe the term ‘design feature’ has not previously been used in tax legislation. In addition to the Exposure Draft introducing a new undefined concept, the EM provides only limited guidance on its intended operation, i.e. the EM merely notes the test is objective and clarifies that the production of commercial benefits does not prevent the arrangement from being a structure arrangement.

We believe the second limb to the structured arrangement definition (subsection 832-210(1)(b)(ii)), is unnecessary. In particular, the mispricing of arrangements between unrelated parties should be evident in all the hybrid mismatches involving unrelated parties that the Exposure Draft seeks to address. The addition of a new and inherently uncertain concept of a 'design feature' is unhelpful and likely to cause confusion around the application of the provisions to transactions undertaken on commercial arm's length terms in open, widely traded markets[1].

If subsection 832-210(1)(b)(ii) is retained, we recommend clarification be provided in the EM that commercial arm's length transactions with no element of mispricing and undertaken in open, widely traded markets would not be considered 'structured arrangements'.

3. Hybrid financial instrument mismatches: Who are 'related persons'?

We query the way two entities are defined as being related persons for the purpose of draft section 832-200(4) and therefore whether they are in a 'Division 832 control group'.

For the purpose of determining which parties are in a 'Division 832 control group', a total participation interest of 50% is required (in the factors contained in subparts (b) and (c)). However, for the definition of 'related persons' in section 832-200(4), only a 25% participation interest is required (in the factors contained in subparts (b) and (c)). These different thresholds add complexity and we are unsure why a lower threshold would also be acceptable as an alternate threshold to parties being in a 'Division 832 control group' for the purpose of defining which parties are 'related persons'.

We query why a new concept of 'related persons' is being introduced into the tax law for the purpose of the hybrid rules when the tax laws already contain numerous provisions that address the concept of 'relatedness' between entities.

4. Division 832-F Branch hybrid mismatch rule

One of the requirements for the branch hybrid mismatch rule to apply is that tax is not paid in the branch country **as a result of** the branch country treating a payment as not being derived in carrying on a business at or through a branch country permanent establishment (**PE**) (see section 832-515(3)). As highlighted in Examples 1.17 and 1.18 of the EM, this provision appears aimed at situations where jurisdictions have differing views of the jurisdiction to which a payment is allocated, or where a payment is incapable of allocation because the branch country considers no PE exists.

The use of the phrase 'as a result of' in section 832-515(3)(b) suggests the branch hybrid mismatch rule would not apply where the branch country does not assert a taxing right

[1] Ie exchange-traded markets

under its domestic law, but would regard a payment as being derived at or through a PE in the branch country (to the extent that was relevant). This is relevant where the branch country asserts taxing rights using a concept other than a PE, (for example the United States). Given not all Australian trading partners utilise the PE concept, we believe it would be worthwhile clarifying in the EM the intended application of section 832-515(3) where taxing rights are asserted (or surrendered) independently of the existence of a PE or where there is a PE under the DTA but the PE is not subject to tax under the domestic rules.

5. Other matters

a) It is unclear as to the date from which the measures contained in the Exposure Draft apply. Though it appears to start to apply from 6 months after Royal Assent, it looks like this period can be shortened if Royal Assent is delayed. This should be clarified so it is clear to taxpayers what the start date may be.

b) Use of 'Back-to-back loan' language – it would be useful if a note was included in the EM confirming whether the same 'back-to-back loan' language and other concepts and examples used in the financial institutions exemption in double tax treaties is also being adopted into the hybrid mismatch rules. It seems that the term should be given the same interpretation, but we would appreciate this being confirmed.

c) We would also welcome some clarity around how draft sections 832-800(7) and (8) interact with draft section 832-800 (4).

d) We note that no thresholds apply to determine which entities may be subject to the hybrid mismatch rules. Further, there are no grandfathering measures being made available. This is problematic, especially for taxpayers who may need to restructure to satisfy these rules.

e) We note the rules would not prevent the anti-avoidance regime from applying if a taxpayer restructures to ensure the rules do not apply. An amendment should be made to Part IVA of the *Income Tax Assessment Act 1936* (Cth) so that the rules cannot apply to restructuring to ensure new Division 832 does not apply to an arrangement. If this cannot be included in the law, the EM should be further refined to reflect this in addition to ATO guidance being issued confirming this position.

f) Capital raising through an offshore permanent establishment – we note that distributions to which proposed section 207-158 applies still result in a debit to the issuer's franking account. Arguably this is punitive where the capital raised funds operations in the foreign jurisdiction. Currently, this result can be alleviated for distributions satisfying section 215-10 of the *Income Tax Assessment Act 1997* (Cth). However, only Authorised Deposit-taking Institution (**ADI**) issuing tier 1 capital instruments are able to access section 215-10. We believe it is reasonable to extend the ambit of section 215-10 to non-ADIs, for example non-

operating holding companies and insurers, issuing instruments for prudential capital adequacy purposes.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours faithfully,

Tracey Rens
President