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By Email

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Dear Sir/Ms,

Exposure Draft Bill: *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017*

Thank you for the opportunity to make a submission on the provisions of the *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017* ('**the ED**').

This submission is organised as follows:

- part 1 examines the provisions of Schedule 2 of the ED, in particular the proposed amendments to Div 768-A ITAA 1997;
- part 2 examines the provisions of Schedule 1 of the ED and the dedicated suite of anti-hybrid measures proposed as Div 832 ITAA 1997; and
- the Appendix contains specific comments on the drafting of some individual provisions.

Unless otherwise noted, and apart from references to provisions in the ED, legislative references in this submission are to provisions of the *Income Tax Assessment Act 1936* ('**ITAA 1936**') or the *Income Tax Assessment Act 1997* ('**ITAA 1997**'), as appropriate.

We appreciate that the current consultation is only on how, rather than whether, to implement BEPS Action 2 and we have fashioned our submission accordingly. Nevertheless, we would encourage Treasury to be cautious and selective in implementing OECD/G20, *Base Erosion and Profit Shifting Project, Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report* ('**the Report**'). Because the Report was produced by committee it was never likely to be entirely consistent, and it does show some signs of compromises; some of the boundaries are quite capricious – compare a country with no corporate tax versus a country with a corporate tax but an exemption for classes of companies versus a country with a corporate tax but an exemption for classes of income.

To some extent Australia has already shown a willingness to be careful: the text of the ED already demonstrates departures from the Report to take into account some recommendations by the Board of Taxation, and further departures have been introduced subsequently. But Treasury will still have to make choices in a number of places between conformity to the Report and policy coherence. Given this choice, our preference would always be for consistent policy appropriate to our national circumstances.

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Secondly, it will be very important to think further about the way that these rules will apply to branches and to foreign source income more generally. The current ED contains rules which will significantly change the treatment of income from foreign branches and foreign sources. Further, the Treasurer has announced that, '*the Government will consult with stakeholders as it develops … branch mismatch rules including through the release of separate exposure draft legislation*' so that more legislation is expected. It will be important that Treasury consult the tax community to ensure that the current ED works properly, that it can sit alongside existing rules in the ITAA 1936 and ITAA 1997, and that the ED and the future Bill work properly together. As we note in the Appendix, as currently drafted, the rules in Div 832 seem likely to over-tax a resident earning foreign source income, and to over-tax a non-resident earning Australian source income in many innocuous situations; and by 'over-tax' we mean an outcome that more than simply neutralises a mismatch. We trust this is not an intended outcome but it seems to us likely to occur based on the current text of the ED.

Furthermore, it will be very important for Treasury to carefully consider and consult with relevant taxpayers in relation to the form of the further "branch mismatch rules". We have considerable concerns in relation to the potential introduction of such rules in Australia. In this regard, it is difficult to see how Australia can properly give effect to such internal branch mismatch rules when Australian tax legislation does not (yet) generally/formally recognise the existence of "dealings" between head office and its branches. (Although in practice some such dealings are acceptable to the Australian Taxation Office (**ATO**).) This very imperfect situation is not a good base upon which to graft branch mismatch rules. Such rules will be of particular concern to a number of taxpayers (principally, banks) that typically operate overseas through branches. It will be important for Treasury to fully consult with these taxpayers as part of the development of these rules. We also note that, having regard to the potential complexity of these rules, we do not consider that it is appropriate that they should commence at the same time as the more general hybrid provisions. Rather, taxpayers should be given a period of time (at least 6 months) from the enactment of these further rules to properly consider their consequences (including, considering whether they need to restructure any arrangements).

Finally, it is very important that the hybrid legislation is supported by adequate and reliable guidance as the intended operation of these provisions is often not self-evident. The tax community would definitely appreciate an EM which is more fulsome and informative than the current draft. On the other hand, we would definitely not like to see the entrenchment of the Report into Australian law by some provision like s. 815-135(2)(a).

1 Proposed amendments to Div 768-A

1.1 Hybrid structure v. corporate-shareholder integration mechanism

It is perhaps unfortunate that the proposed amendments to Div 768-A have been included in the same package as the measures on how to handle cross-border hybrids. In our view it is important to distinguish between hybrid instruments and structures, on the one hand, and corporate-shareholder integration mechanisms on the other. In our submission, the amendments to Div 768-A should address hybrid structures but not interfere with corporate-shareholder integration mechanisms. The measures in Div 832 go some way to preserving this distinction [s. 832-500(1)(b)] but no similar protections exist in the Div 768-A amendments.

The distinction we are drawing is between:

- the problem which anti-hybrid measures are trying to grapple with: to reconcile disagreements between two (or more) countries about the classification and treatment of either (i) a financing instrument or (ii) an entity, versus
- the problem which corporate-shareholder integration mechanisms are trying to address: to arrange for corporate income to be taxed once and in the hands of ultimate owners (including removing cascading of tax as income passes through layers of entities).

Many countries (including Australia) accomplish the second piece of tax design through a dividend-paid deduction system. In Australia, a dividend-paid deduction system exists in provisions such as ss. 46FA, 120, 387 and 394 ITAA 1936 in addition to our imputation system. In other countries, dividend paid deduction systems are a common and simple way of achieving a single layer of tax that is collected either (i) at the border by the imposition of a withholding tax when distributions flow offshore, or (ii) in the hands of resident shareholders.

A dividend-paid deduction system gives the appearance of a D/NI outcome, so far as the recipient country is concerned, but in fact there is no tax hole where the impact of the D/NI outcome has been negated at the border by imposing a withholding tax on the recipient of the deducted distribution. For example, the US withholding tax rate on income not effectively connected to a US trade or business is prima facie 30% of the gross payment [s. 881 Internal Revenue Code] although it can reduced by treaty.

Thirty percent tax on the gross payment may well be more than enough to neutralise a deduction and non-inclusion. So, even though a dividend-paid deduction system can give the appearance of a tax hole (ie, deducted by the company paying the dividend and not included in income in the recipient country), nevertheless an appropriate amount of tax is being collected:

- it is collected from the shareholder (not the entity) at the border in the way that was intended under the corporate-shareholder integration mechanism chosen by the source country; and
- the tax is collected in the source country not the residence country.

It is a shortcoming of the Report that it does not acknowledge the impact and significance of withholding taxes. This is perhaps understandable given how many European countries are represented in the OECD membership and so withholding taxes do not figure in their thinking because most withholding has been eliminated by EC Directives. But not taking into account the effect of withholding taxes is unfortunate because it creates a misleading impression. The justification given in the Report (‘*withholding taxes alone do not neutralise the hybrid mismatch as withholding taxes, where applicable, often are imposed with respect to equity instruments*’ [Report, para 407]) is somewhat elusive in its logic, and wrong in some cases as a matter of fact. In the banking industry, for example, a 10% withholding tax imposed on the gross payment will almost always exceed tax imposed at 30% tax on net income. The oversight creates the impression of a tax hole where none would actually occur.

In our submission, the proposed amendments to Div 768-A should be redrafted to clarify that they are not enlivened in cases where the distribution has been deducted by the payer pursuant to a dividend-paid deduction system and withholding tax has been imposed on the recipient by the source country.

This would align the treatment of dividends received by Australian companies from subsidiaries in countries which use a dividend-paid deduction system with the treatment of dividends paid by subsidiaries in countries that use other kinds of corporate-shareholder integration systems – exemption systems, for example.

Or to put it more concretely, there is no principled basis for Australian tax law to distinguish between an Australian company with a real estate investment trust (‘**REIT**’) subsidiary in Canada or the US and another Australian company with a REIT subsidiary in the UK or Singapore. Yet that is exactly what these amendments will do.

1.2 Impact of proposed amendments on conduit foreign income

As we mentioned in our meeting, one important implication of the proposed amendments to Div 768-A will be to frustrate Australia’s tax policy with respect to conduit foreign income in certain situations – that is, income coming from subsidiaries in countries with dividend-paid deduction systems.

Australia's tax policy position has been that it is not appropriate for Australia to impose tax on income from a foreign source that is passing via an Australian resident entity to non-resident investors. It has been a permanent feature of our tax regime for income passing through resident trusts (in Div 6 ITAA 1936 and Div 276 ITAA 1997) and a feature of our law for income passing through resident companies since 1994 (former Div 11A ITAA 1936, s. 46FA, and Div 802 ITAA 1997). Indeed, the scope of these provisions was substantially expanded by the 2005 amendments so that more types of foreign source income could pass through Australian companies without triggering Australian corporate tax or withholding tax.

The Objects clause to Div 802 ITAA 1997 makes this policy abundantly clear:

> *The objects of this Subdivision are:*
>
> *(a) to encourage the establishment in Australia of regional holding companies for foreign groups; and*
>
> *(b) to improve Australia's attractiveness as a continuing base for its multinational companies;*
>
> *by providing relief from tax on *distributions by *Australian corporate tax entities to *members who are foreign residents or other Australian corporate tax entities if those distributions relate to *conduit foreign income.*

The amendments to Div 768-A will impede that policy by imposing tax on dividends paid to an Australian company from offshore subsidiaries in some countries, even though that income is on-paid to non-resident shareholders.

At the moment, Australian tax law gives effect to the policy of not taxing conduit income through the combined operation of four rules:

- s. 768-5 as currently drafted prevents tax in the hands of the first onshore company receiving a dividend from a foreign subsidiary;
- s. 46FA or s. 802-20 prevents tax in the hands of another onshore company when that income is paid through a chain of onshore entities;
- s. 802-15(1)(b) removes dividend withholding tax on payment of the (unfranked) dividend to non-resident shareholders; and
- s. 802-15(1)(a) ensures that the dividend is not included in the non-resident's assessable income.

The present Div 802 ITAA 1997 was enacted by *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005* and its operation was fundamentally premised on the continued operation of s. 23AJ ITAA 1936 [now Div 768-A] to make the dividend received by the first onshore company non assessable non-exempt ('**NANE**') income. Div 802 ITAA 1997 would take effect thereafter.

The proposed amendments to Div 768-A will undo that model for income flowing through Australia from some foreign subsidiaries:

- the dividend received by the first onshore company would now be included in assessable income if it is paid by a subsidiary in a country with a dividend-paid deduction system;
- this means the amount can no longer meet the definition of 'conduit foreign income' [s. 802-30(2)] and will have to pass to another onshore entity as a franked dividend if it is not to be taxed again in the hands of the second company; and
- the last onshore company will have to pay the amount to non-resident shareholders as a franked dividend if Australian dividend withholding tax is to be removed.

For an Australian company with a large foreign shareholder base and operations in countries with a dividend-paid deduction system, the potential leakage of inappropriate Australian tax could be substantial.

In our submission, the proposed amendments to Div 768-A should be redrafted to clarify that they are not enlivened in the case of conduit foreign income. This might be done by an amendment to Div 802 to include dividends received by the first onshore entity as NANE income under Div 802 notwithstanding the proposed amendment to Div 768-A – ie, foreign dividends are not only earmarked at the first point onshore as conduit foreign income, but also attract NANE treatment at that point because of that circumstance. No doubt there are other options for achieving this result. But it is important to ensure that some adjustment is made to the proposed amendments to ensure that they do not undermine Australia's policy with respect to conduit foreign income.

1.3 Application to dividends received by CFCs

At present, the rules which compute the amount of attributable income of a controlled foreign company ('**CFC**') start from the hypothesis that the CFC is a resident of Australia [s. 383 ITAA 1936]. This has the effect that Div 768-A (as modified by s. 404 ITAA 1936), is attracted: non-portfolio dividends received by a CFC from a foreign company will not be included in the attributable income of a CFC.

The amendments to Div 768-A will flow through to CFCs, effectively removing the exclusion for a dividend received by a CFC which has been deducted by the payer, unless the legislation is specifically amended to adjust the way Div 768-A works when computing the attributable income of a CFC.

Cross-border dividends. One difficulty is that the proposed amendment will see a hybrid D/NI outcome where none actually exists. For example, if Company A pays a deductible dividend to Company B (a CFC), and the payment is taxed in Country B in the hands of the CFC, this fact would not be relevant: because the dividend is being deducted in Country A, Div 768-A will not available. In short the dividend will be taxed in Country B and in Country A, and with no credit for underlying Country B tax.

In our submission, the amendments being proposed should not extend to calculating the attributable income of a CFC because this will not only pose compliance problems for attributable taxpayers, it will produce asymmetric and inappropriate outcomes. In a world with anti-hybrid rules, the proposed amendment will cause difficulties because of the multiple, competing and potentially inconsistent outcomes which can arise depending on how any one or more of 3 countries react. For example, is the D/NI result to be negated by:

- the country where the CFC is resident including the dividend in income under its ordinary rules amended to include deductible dividends in income;
- the country where the payer is resident denying a deduction for the dividend under its anti-hybrid rules (**primary response**);
- the country where the CFC is resident including the dividend in income under its anti-hybrid rules (**secondary response**); or
- Australia imposing tax on the parent by including the dividend in the attributable income of the CFC pursuant to this amendment.

There is no obvious reason to believe that multiple rules will not be enlivened by multiple countries, but in our submission, if there is hybridity, it is a matter for two countries to solve – the country where the paying entity resides and the country where the CFC resides – by the appropriate interaction of their tax systems. It is not a situation where Australia should further complicate matters, and so the amendments to Div 768-A should not extend to dividends received by CFCs.

We note that the Report alludes to this issue [para 36 ff] but approaches the other side of the question. It examines whether the country where the CFC resides should take into account the operation of the CFC rules of a third country in deciding whether a D/NI outcome is occurring and is currently reflected in s. 832-940(3) and s. 932-945(3). That position makes sense, but it is insufficient. A universal rule in that country (akin to Div 768-A or the amendments to the EU Parent-Subsidiary Directive) will not be sufficiently nuanced to turn off the inclusion of the dividend in the CFC's income just because the

parent is being taxed. Consequently, there would need to be both a primary and secondary rule in order to determine whether the CFC country or Australia negates the D/NI outcome.

But we remain of the view that the simplest solution is to leave the matter to be resolved by the country where the paying entity resides and the country where the CFC resides. Australia should not further complicate matters by insisting that Div 768-A extends to deductible dividends received by CFCs.

Same country dividends. The inappropriateness of applying the amended Div 768-A to CFCs is even more pronounced if the CFC is resident in the same country as the payer. There is no actual cross-border hybrid mismatch; but a cross-border mismatch is manufactured by the CFC rules deeming the CFC to be resident in Australia.

1.4 International experience

Before leaving this point we wanted to draw attention to the UK provisions enacted to deal with deductible dividends. The EM notes that '*the United Kingdom enacted laws to address hybrid mismatch arrangements with effect from 1 January 2017*' [para 1.16]. The UK also enacted a more general rule to address deductible dividends in s. 931N *Corporate Tax Act 2009*. In general terms, UK law exempts most dividends from tax in the hands of shareholders but s. 931N provides,

> (2) The distribution does not fall into an exempt class if—
>
> (a) the distribution is made as part of a **tax advantage scheme**, and
>
> (b) the following condition is met.
>
> (3) The condition is that a deduction is allowed to a resident of any territory outside the United Kingdom under the law of that territory in respect of an amount determined by reference to the distribution.

Section 931V *Corporate Tax Act 2009* defines a 'tax advantage scheme' as '*a scheme the main purpose, or one of the main purposes, of which is to obtain a tax advantage (other than a negligible tax advantage)*.' There is an extensive definition of 'tax advantage' in s. 1139 of the *Corporate Tax Act 2010*.

The obvious point is that the UK equivalent to Div 768-A is driven by the same mismatch idea but it is qualified by the same logic that underlies their anti-hybrid regime and our Div 832 – namely, that the deduction / exemption mismatch is conscious, deliberate and abusive. In our submission, the proposal in Div 768-A should be limited in a similar way.

1.5 Transitional rule

As we noted in our meeting, in our submission there are three problems in the current drafting of the transitional rules for AT1 capital instruments [item 8, Part 3 of Schedule 2] which should be rectified:

- item 8(1) currently refers only to AT1 capital instruments issued by an ADI. We are aware of insurance companies that also have AT1 capital instruments on issue. There is no policy basis for having the transitional rule differentiate between ADIs and other APRA-regulated entities. They should be entitled to the same transitional rule as instruments issued by ADIs;
- items 8(1) and (2) use the language of an available call date as the cut-off date for the grandfathering. As we noted, there may be circumstances where APRA would not allow an instrument to be called at the first available date. Consequently, there should be a clarification that grandfathering continues until the first available call date provided APRA has allowed the instrument to be called and any other condition, not within the control of the issuer, has been satisfied; and

- item 8(2) contains a transitional rule for distributions 'made **before** …' the call date. As we noted, it is very common for a distribution on an AT1 capital instrument to be payable ***on*** the call date. There should be a clarification that the proposed transitional regime continues to apply to a distribution on the instrument on or around the call date.

2 Proposed anti-hybrid measures

This part of our submission examines the terms of proposed Div 832 – ie, schedule 1 of the ED. We have included specific comments on the drafting of individual provisions and their interaction with other rules in the Appendix.

2.1 Preferring policy coherence and administrative feasibility

We have made the point already but it warrants being repeated – the Report was the product of a committee process and so it is not entirely coherent. The twin touchstones of 'D/NI' and 'DD' may have intuitive appeal but they can produce results that are sometimes arbitrary and capricious.

The flaws in the Report sometimes operate for and sometimes against a government (or taxpayers). We have listed a few examples where (i) the proposed Div 832 won't apply even though it probably should if the rubric of 'D/NI' and 'DD' were being taken seriously, and (ii) cases where Div 832 could apply even though it shouldn't:

- Div 832-C could apply to a dividend received by an Australian company from a company where the classical system of corporate tax is relieved by a deduction, but not from a subsidiary in a country with no corporate tax at all;
- Div 832 could apply to a double-dip lease structure where both countries offer depreciation deductions for the same item of plant, but not where one country offers an investment tax credit instead;
- Div 832 could still apply if a receipt is not included in income even though the receipt will reduce the recipient's cost in a current asset;
- Div 832 could still apply if a receipt is not included in income even though the receipt will cause a related deduction not to be available;
- Div 832 could still apply if a payment was deducted but then subject to (a larger amount of) withholding tax by the source country; and
- if an Australian company claims a deduction under s. 46FA then Div 832 can apply, but if it claims NANE treatment under Div 802 then Div 832 does not.

Moreover, the drafters of the Report seem to have little appreciation of just how difficult it will be to comply with these rules. For example, the drafters suggest at various places –

- the rules will not require any detailed knowledge of foreign tax laws [Report, paras 84-86];
- it is plausible to ask taxpayers to undertake the analysis of income and deductions on an item-by-item basis [Report, para 117]; and
- it is plausible to expect members of a tax consolidated group to prepare tax returns as if they were not consolidated so that two tax administrations can identify any dual deductions and dual inclusion income [Report, p 315-16].

We could go on. Our point is simply that the Report has shortcomings and Treasury should be ready to ignore it in favour of policy coherence, administrative feasibility and consistency with Australian tax policy principles.

2.2 These rules have to be complied with; their impacts can't be excluded

Some of the discussion in our meeting gave us the impression, perhaps mistakenly, that these rules are seen as / intended to function as a deterrent to taxpayers; taxpayers are in a position to control their situations and will be encouraged by these rules to organise their affairs in a manner that will avoid hybrid outcomes.

While we can appreciate a view that these rules are meant to change behaviour, we doubt this will always be possible. Certainly the design of some instruments and some intra-group structures are initially within the control of the taxpayer, but taxpayers can't prevent a government changing the tax base or tax rates: a government might add (or remove) amounts from income or as deductions, change tax incentives from credits to deductions, shift from an exemption system to a dividend-paid deduction system, reduce the tax rate on certain types of income or change its views about the classification of various foreign entities. Some of these events might occur through something as simple as a change to the practices of the revenue authority. Indeed, some of them might even occur as a result of strategic behaviour taken by the governments of certain countries keen to exploit areas of incoherence in the Report. Consequently, transactions and structures that may escape these rules one day, may be within them the next, and vice versa. It is unrealistic to expect that taxpayers can quickly and costlessly unwind situations where the ground-rules have been changed.

Consequently, the anti-hybrid regime has to be written on the basis that taxpayers will have to examine Div 832 in many situations, and that means taxpayers must be able to ascertain their obligations fully and accurately, based on the text of the law, supplemented by administrative guidance that is both reliable and consistent with the law.

The current text still needs further development.

Ordering rules. The ED contains some ordering / priority rules:

- the first listed hybrid mismatch type is given effect to and others are rendered inoperative [s. 832-50];
- the inclusion in income under s. 832-165(2) operates notwithstanding s. 230-20 (which ordinarily gives priority to the Taxation of Financial Arrangements ('**TOFA**') rules in Div 230, by reducing income inclusion under other provisions) [s. 832-165(5)];
- the formula in s. 832-105(1) ['apart from this section, the entity would have an Australian income reduction amount …'] suggests that subsection (2) operates only after all other deduction (and non-deduction) provisions have operated; and
- s. 832-175(2) caps the amount included in assessable income at the amount of the payment, and subsection (3)(a) implies that other inclusion provisions operate first, with Div 832 operating if needed and only for the balance.

Nevertheless, there would still be conflicts with other provisions which also claim to be the final rule in play for income and deductions such as ss. 815-110, 815-210, 82KL, 82KK, 177B and s. 4(2) *International Tax Agreements Act 1953*.

CFCs. There is currently no indication about whether an Australian attributable taxpayer will have to apply Div 832 in calculating the attributable income of a CFC (which means it would unless the ED is amended). We currently switch off several Australian laws when calculating attributable income – debt-equity rules [s. 389A], TOFA [s. 389(ba), thin capitalisation rules [s. 389(c)], the CFC rules [s. 389(a)], imputation [s. 389(b)], Australia's tax treaties [s. 388], Divisions 165-CC and 165-CD [s. 427(ba)], and so on. The provisions of Div 832 should be added to the list.

If this isn't done, the same problems will arise from the conflicting anti-hybrid rules of the payer country, the recipient country and Australia. And there could even be competition between multiple Australian rules – whether a transaction with a CFC is to be neutralised through the primary or secondary response rules, through the imported mismatch rules or through the CFC rules where the attributable taxpayer is also making a payment.

Forex. Another substantive omission is how to deal with mismatches that are attributable to timing rules and currency movements – eg, the Australian deduction is recognised when incurred as $1, while the amount included in income is reported when received as the AUD equivalent of $0.95. At the moment it is not clear the ED would allow this permanent difference to be ignored even though the Report is clear that the 'missing' $0.05 is not meant to be captured:

> *53. Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment (including through the application of transfer pricing) do not fall within the scope of the hybrid mismatch rule. If the amount of the payment is characterised and calculated in the same way under the laws of both jurisdictions, then differences in the value attributed to that amount under the laws of the payer and payee jurisdictions will not give rise to a D/NI outcome.*

Indeed, many of the detailed conditions, exceptions and qualifications found scattered throughout the Report are omitted. Some of the most important limitations which have not been drafted include:

- apparently quantifying the size of amounts which are deducted or not included for the purposes of these rules is not meant to be affected by adjustments caused to income or deductions by the application of transfer pricing rules [Report, para 53];
- the hybrid financial instruments rule '*should not apply to a payment by an investment vehicle that is subject to special regulation*' [Report p. 24]; and
- the hybrid financial instrument rule should not apply to '*arrangements for the supply of services such as lease or licensing agreements; arrangements for the assumption of non-financial risk (such as insurance) or to asset transfers that do not incorporate the payment of an equity or financing return*' [Report p. 36]. We note that some lease arrangements are currently defined as 'debt interests'.

2.3 Drafting style

We appreciate that at this stage of the legislative process, it is very unlikely that there can be significant changes to the text of the ED, but we wish nevertheless to put on record our view that this is among the most obscure pieces of tax legislation with which Australian taxpayers and advisers have ever been confronted. It is certainly as difficult as TOFA, tax consolidation, the AMIT rules or value shifting – and they set a high bar!

Given that there is limited prospect for significant changes to the text, we will mention just a few provisions where, in our submission, the drafting style could be improved by greater precision:

1 The **test entity** and the **liable entity**. Because much of the focus of these rules is on the complications arising from transparent entities and consolidation regimes, the drafter has created the notion of the liable entity [s. 832-1000]. As currently drafted, that definition gives the clear impression that there are two distinct entities to analyse – the liable entity (the entity on which tax is imposed) and the test entity (where income and deductions are being calculated and reported). The impression that there are two different entities in play is reinforced by provisions such as s. 832-585(1)(a) or s. 832-725(1)(a): there can be more than one liable entity in respect of the income of a single test entity. It is only after a reader has become very familiar with these rules that it becomes apparent the test entity is sometimes also the liable entity. That is not found in the definition in s. 832-1000 or even the Note to the section; it has to be observed from isolated provisions such as s. 832-725(2) items 2, 3 where it is specifically contemplated that the liable entity and the test entity can be the same entity.

This drafting is unnecessarily confusing and could be easily solved in the definition in s. 832-1000.

2 **Attributable**. The ED requires for each type of hybrid mismatch (other than an imported mismatch) that the D/NI or DD outcome be 'attributable' to something [ss. 832-500(1)(b), 832-505(1)(b), 832-580, 832-650, 832-720].

The meaning of 'attributable' would ordinarily be something like: the difference in treatment or the identity of the payer or the identity of the recipient is an important cause of the mismatch. (Perhaps, in the case of hybrid payers, reverse hybrids and deducting hybrids it might even have to be the sole cause.)

With regard to hybrid financial instruments, the EM argues that in deciding whether the D/NI outcome is 'attributable' to 'differences in treatment …' or attributable to some other circumstance –

> *1.98 … the following factors should be disregarded:*
>
> * *the taxable status of the recipient, the payer or any other entity;*
> * *if the payment is made under a debt interest or an equity interest, the circumstances in which the interest is held …*

We note in passing that there is no legislative basis for these views.

The EM then purports to prescribe a test for ascertaining what is and isn't 'attributable' to a particular circumstance –

> *1.100 In contrast, if the hybrid mismatch is attributable to the tax treatment of the instrument and the mismatch would have arisen in respect of payment between taxpayers who are not entitled to any special tax treatment, the hybrid financial instruments rules will continue to apply.*

With regard to hybrid financial instruments, this conundrum – whether the terms of the instrument must actually cause the D/NI outcome or whether it need only be one of many possible explanations – is mentioned several times in the Report:

> *51. The adjustment to the tax consequences of a payment under a hybrid financial instrument should be confined to those that are attributable to the tax treatment of the instrument itself. The adjustment is not intended to impact on tax outcomes that are* ***solely*** *attributable to the status of the taxpayer or the context in which the instrument is held* ***[emphasis added]***

The same position is put in para 96:

> *96. The hybrid financial instrument rule does not apply to mismatches that are solely attributable to the status of the taxpayer. Where, however, the mismatch can also be attributed to the tax treatment of the instrument (i.e. the mismatch would have arisen even in respect of payment between taxpayers of ordinary status) the hybrid financial instrument rule will continue to apply although the adjustment may not, in practice have any impact on the tax position of the parties to the arrangement.*

Example 1.5 in the Report says the rule is not meant to be enlivened when interest is paid to a Sovereign Wealth Fund (except that in the Example there is no hybrid aspect to the instrument because both countries agree the instrument is debt). But the text of Example 1.5 [para 4] says the rule will be enlivened if there would have been a mismatch had the amount been received by a taxpaying entity.

So the text of the Report is reasonably consistent in taking the position that the fact of a hybrid instrument does pollute a situation even where the D/NI outcome is more directly ascribed (or 'attributable' to) to the exemption. Hence, the idea expressed in the Report is more akin to 'sufficient to result in a D/NI outcome', than akin to 'necessary to create the D/NI outcome.' There must be some doubt whether the word 'attributable' used in the ED accurately captures this difference. This doubt cannot be resolved by text in the EM which is not supported in the ED.

It is also worth noting that the same word, 'attributable,' is used in the ED for the entity-based hybrid mismatch requirement definitions. The term is not used in the Report for these hybrids. Consequently, even though the same conundrum

arises – whether the fact that the payer or recipient is a hybrid when that circumstance is just one of many reasons for the outcome – is not analysed in the Report.

In our view, because these mismatches are defined in a way that is specific to the identity of the payer or the recipient, the context suggests that the word 'attributable' should carry a meaning more akin to 'the principal cause for' but there must be some doubt about this.

The drafting should be clarified by adopting a less uncertain term and greater precision.

3 **Differences in treatment** and **the terms of the interest**. Our third example is also from the drafting of the hybrid requirement in s. 832-500:

> *(b) the [D/NI] mismatch … is attributable to differences in the treatment of the debt interest, equity interest or derivative financial arrangement, arising from the terms of the interest or arrangement;*

This apparently simple requirement poses hidden questions.

First, the language of 'differences in … treatment' poses the obvious question: different from what? The payment that gives rise to the mismatch must be made under a debt or equity interest or under a derivative financial arrangement [all as defined under Australian law], but what is the standard against which the treatment of the receipt is to be judged [again applying Australian law]?

The obvious answer is a cross-border disagreement where one country both classifies and taxes the instrument as debt **under its laws**; and the other country both classifies and taxes the instrument as equity **under its laws**. But is there also a 'difference in treatment' if –

- the payer country views the instrument as debt (and gives a deduction) and the recipient country also treats the instrument as debt (but does not tax interest) – ie, there is no disagreement about classification but there is still a D/NI mismatch; or
- the payer country views the instrument as debt (and gives a deduction) but under Australian law the instrument is an equity interest – ie, there is no disagreement about classification until Australian definitions are applied to the instrument.

Another omitted element from this definition is that the difference in treatment is attributable to a difference in classification and/or treatment between two countries. The Report is much clearer in the way it insists on this notion of a cross-border disagreement. For example, Recommendation 3.1 says –

> *A disregarded payment is a payment that is deductible **under the laws of the payer jurisdiction** and is not recognised **under the laws of the payee jurisdiction**. **[emphasis added]***

Finally, the difference in treatment must arise '***from** the terms of the interest or arrangement*.' It is not obvious what this adds to the requirement, and how it fits with 'attributable'. It seems the function of this phrase is to rule out situations where (say) the non-taxation is due to the operation of the law of the foreign country – the payer country views the instrument as debt and gives a deduction and the recipient country also treats the instrument as debt but does not tax interest. If that is so, then this might clash with the discussion of 'attributable' above.

2.4 Knowledge of foreign tax laws

The EM adopts the same hopeful view as the Report that the anti-hybrid rules will not impose a significant compliance burden on taxpayers to become familiar with, and continually monitor, the tax laws of other countries:

> *1.94 … it is not necessary that the entities know the precise treatment of the payment in the counterparty's taxable income calculation. A taxpayer … should be able to determine a reasonable expectation of the likely tax outcome for the counterparty based on its knowledge of the counterparty's identity and the tax rules in the counterparty jurisdiction.*

This is more than a little hopeful. First, it is only when the hybrid mismatch is defined under s. 832-490 that the payer's position depends upon how the payment **might be expected** to be treated in the recipient's country. Hybrid mismatches under s. 832-510 and all the other hybrid mismatches adopt a stricter test, making the payer's position (or the recipient's position) depend upon whether the payment *actually* gives rise to a relevant mismatch.

Secondly, given that the stricter standard applies to almost all cases, there is a great deal of foreign law which Australian taxpayers will have to monitor, and in detail, in order to know whether there are any impacts for them under Div 832:

- the tax base – is an amount 'included in the tax base of the law of a foreign country', does an amount give rise to 'a foreign income tax deduction', determined item-by-item,
- timing rules – what is the 'foreign tax period' of a foreign country and in which tax period will each item of income or deduction be recorded,
- tax rates – what is the 'rate of foreign income tax' on this kind of amount and is it lower than 'the rate that would ordinarily be imposed on interest income …',
- does the foreign country have CFC rules and have they been enlivened to 'include an amount in the tax base of another entity …',
- does the country have a foreign tax credit system and is the liable entity 'entitled under the law of the foreign country to a credit … in respect of an amount of foreign tax,'
- is a foreign entity regarded as 'a resident of the foreign country' under its laws,
- does the foreign country have corporate consolidation rules; do they combine 'the income or profits of the test entity … with income or profits of one or more other entities' or work in some other way,
- does another country have corporate consolidation rules; do they combine 'the income or profits of the test entity' with no-one or with different entities,
- does the foreign country have tax-transparent structures and who is the 'liable entity' in respect of payments going to a foreign entity under its law,
- for non-resident investors in a tax-transparent structure, does the law of their country view them as a 'liable entity' in respect of payments going to a foreign entity, and
- does the country have an anti-hybrid regime, does it 'correspond to Div 832,' is it being enlivened, is it a primary or a secondary response provision that is operating, and will it 'fully neutralise' a mismatch?

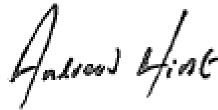
And taxpayers will need to monitor these matters in respect of multiple countries including the **formation country** and the **investor country** and countries in between, as well as every country from which the effect of a mismatch may go unchallenged and be imported into Australia.

These matters are not self-evident and they have to be analysed correctly since liability most often depends upon whether the payment or structure **actually** gives rise to a mismatch.

* * * *

Thank you for the opportunity to comment on the ED. We trust these comments are useful to your work. Please contact us if anything in this submission is unclear or requires further clarification.

Yours sincerely,



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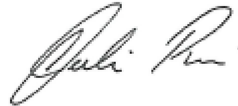

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Appendix

Examples of drafting problems

We have noted below a number of provisions which seem to us to raise particular drafting problems.

Sections 832-15 and 832-25: time at which ‘payment’ happens. At present there appear to be two competing timing rules to supplement determining when ‘payment’ happens:

- s. 832-15 which provides that payment happens when ‘another entity (the recipient) … is entitled to receive the payment from the payer’; and
- s. 832-25 provides that payment happens when a loss arises which represents ‘a payment that will be made to another entity (the recipient) in a later income year’.

One of these rules seems unnecessary, but if they are both to remain there needs to be an ordering rule between them.

The ED should also provide that the actual payment is no longer a ‘payment’ for the purposes of the Division if one of these rules has already been enlivened.

Section 832-515(4): inclusion in income taxed at a low rate. One of the more imponderable provisions in the ED is s. 832-515(4). Section 832-515 deems an amount ‘not to be subject to foreign tax’ if it is taxed at a rate less than the rate ordinarily applied to interest income. In our discussions it was suggested that this provision is only enlivened if two conditions are met: (i) the instrument is already a hybrid under the definition in s. 832-495, but (ii) an amount is included in income but it is taxed at a concessional rate.

It is not obvious that the first requirement needs to be met in order for s. 832-515(4) to be enlivened. Rather, it seems to be sufficient to enliven the provision if the amount is included in income that is taxed at a concessional rate.

Subsection (3) says it is relevant for situations where ‘a deduction/non inclusion mismatch … would not arise apart from this section …’ so it is clearly expanding the earlier rules. But how much of s. 832-495 and the following sections does it replace?

- s. 832-495(1)(a) will still need to be met, and its operation / meaning is not affected by s. 832-515(4) – the instrument must be debt, equity or a derivative (but not necessarily a cross-border hybrid);
- s. 832-495(1)(b) will still need to be met, and its operation / meaning is not affected by s. 832-515(4) – there must be an expectation of a D/NI outcome;
- s. 832-495(1)(c) will need to be met – the mismatch must meet the hybrid requirement in s. 832-500. Paragraphs (a) and (c) of s. 832-500 remain unaffected – the instrument must be debt, equity or a derivative and not have a term <3years, etc;
- but s. 832-500(1)(b) is replaced by s. 832-515(4) which provides its own hybrid concept instead of the requirement in s. 832-500(1)(b). Subsection (4) provides,

  (4) *The *deduction/non-inclusion mismatch is taken to be attributable to a difference in the treatment of the thing if the application of the lower rate mentioned in paragraph (2)(b), instead of the ordinary rate, to the relevant amount of income or profits is attributable to a difference in the treatment of the thing.*

Just what the drafter believes is accomplished by this provision is more than a little obscure. On one reading, it says nothing, or else it is self-fulfilling – ‘*the mismatch is taken to be attributable to a difference in the treatment of the thing if … [the application of the lower rate] is attributable to a difference in the treatment of the thing.*’

But it also seems to make a mere rate differential sufficient to trigger a hybrid financial instrument.

Section 832-515(5). This section is intended to convert an amount of lightly taxed income into a smaller amount of fully-taxed income. It is expressed to apply to 'the amount of a payment that is treated as being *subject to foreign income tax ***only because of this section*** …' This seems to us to be mistaken: the operative provision is enlivened *inter alia* because 'the amount [is] subject to foreign income tax' and so the operative provision says that amount is 'taken ***not to be*** *subject to foreign income tax …'

Section 832-715(3)-(5): amount of a DD mismatch. For a deducting hybrid the impacts of the regime occur as the consequence of a long series of steps:

1. The hybrid outcome is neutralised by disallowing a deduction for the payment up to the amount of the hybrid mismatch. [s. 832-110]
2. The amount of the hybrid mismatch starts with the amount of the deduction/deduction mismatch [s. 832-715(2)(a)]. This term is defined in s. 832-925 as the lesser of the amount of the Australian income reduction and the foreign income tax deduction.
3. That amount can be reduced by the amount of any dual inclusion income [s. 832-715(3)]. There is no rule about what happens if the (two or three) countries include different amounts – is it the greater or the smaller?
4. Technically, the amount of dual inclusion available at step 3 reduces the Australian income reduction amount or the foreign tax deduction. This suggests the amount (whatever its size) is then meant to feed back to step 2 where it can change the decision about which is the lesser figure.
5. Subsection (5) is then meant to affect the computation but its meaning is deeply mysterious. Where its conditions are met the amount of 'the foreign income tax deduction [ie, one of the two possible step 2 amounts] is reduced' so there is a smaller amount of dual deduction to be reduced at step 3 and then neutralised. We suspect exactly the opposite effect was intended but we cannot be sure.

Definitions of 'subject to foreign tax' and 'dual inclusion income'. The concept of 'dual inclusion income' features in calculating the amount of the hybrid mismatch under Div 832-J [hybrid payer] and 832-L [deducting hybrid], and the amount which can subsequently reverse [under Div 832-D] the impact of a previously denied deduction.

The definition in s. 832-1020 requires that the amount be 'subject to foreign income tax' which is itself defined in s. 832-945. Subsection 832-945(2) excludes an amount from being subject to foreign tax if –

> *… an entity is entitled under the law of the foreign country to a credit … in respect of the amount for foreign tax (other than a withholding type tax) payable under a tax law of a different country (including Australia).*

This provision will operate inappropriately in the case of branches if the country where the parent is located relieves double taxation of foreign branch profits by means of a foreign tax credit rather than an exemption.

The Report goes to some length to explain why income which is subject to a foreign tax credit should be regarded as included in income in full, contrary to the treatment being proposed in the ED:

> *126. Double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a* ***foreign tax credit granted by the payee jurisdiction*** *should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction.*

It is not clear why the ED takes a contrary position especially since the position in the ED will lead to inappropriate outcomes. Example 1.11 in the EM shows just this kind of inappropriate result:

- assume ABC Co is a US resident company with a PE in Australia;
- ABC Co earns (through its Australian PE) $100 in income from sales of widgets and incurs $20 of interest expense paid to an Australian resident Bank;
- Australia will tax the profits of ABC Co's local branch [$80 x 30% = $24];
- Australia will tax resident Bank on the $20 of interest income [$20 x 30% = $6]; and
- the US will tax ABC Co on (net) worldwide income with a credit for Australian tax [$80 x 35% = $28 (US tax) - $24 (foreign tax credit) = $4 (net US tax payable)].

This is the correct result, but the measures in the ED will change that result because the amount reported in the US is not 'dual inclusion income' because it is not 'subject to foreign income tax' [s. 832-954(2)] – ie, ABC Co 'is entitled under the law of the [US] to a credit … in respect of the amount for foreign tax … payable under a tax law of … Australia'. Given that the US is not enacting rules which are similar to Div 832 (although it has apparently just enacted its own idiosyncratic anti-hybrid measures), apparently Australia will now deny a deduction for the $20 paid to Bank. This will mean:

- Australia will tax the profits of ABC Co's local branch [$100 x 30% = $30];
- Australia will still tax resident Bank on the $20 of interest income [$20 x 30% = $6]; and
- the US will tax ABC Co on (net) worldwide income with a credit for Australian tax [$80 x 35% = $28 (US tax) - $30 (foreign tax credit) = $0 (no further US tax payable)].

And a different but also incorrect result would occur if the countries in Example 1.11 are reversed – that is, if an Australian company invests offshore, say, by holding commercial real estate (ie, activities that do not amount to a branch). Ignoring these rules,

- assume ABC Co is an Australian resident which owns land in the US;
- ABC Co earns $100 rent from the tenant in the US and incurs $20 of interest expense paid to a US resident Bank;
- the US will tax ABC Co on its US-source income on a net basis [$80 x 35% = $28];
- the US will tax the US resident Bank on the $20 of interest income [$20 x 35% = $7]; and
- Australia will impose no further tax on the profits of ABC Co's foreign operations [$80 x 30% = $24 (Aust tax) - $28 (FITO) = no further tax payable].

Again, this is the correct result.

But once the measures in the ED are added, the result changes because the amount reported in Australia is not 'dual inclusion income' because it is not 'subject to Australia income tax [s. 832-940(2)] – the amount of 'foreign income tax … paid [by ABC Co] in respect of the amount counts toward a tax offset for [ABC Co] under Division 770.' Given that Australia is the primary response country in this situation [s. 832-725(2), item 2], Australia will now deny a deduction for the $20 paid to US Bank. This will mean:

- the US will still tax ABC Co on US-source net income [$80 x 35% = $28];
- the US will tax the US Bank on $20 interest [$20 x 35% = $7]; and
- Australia will now tax ABC Co on the entire $100 of rent [$100 x 30% = $30 – $28 (FITO) = $2].

On the other hand, if the activities in the US amount to carrying on business through a permanent establishment there, yet another result will happen –

- the US will still tax ABC Co on US-source net income [$80 x 35% = $28];
- the US will tax the US Bank on $20 interest [$20 x 35% = $7]; and
- Australia will not allow ABC Co to deduct the interest expense [s. 8-1] and will not tax the rent [s. 23AH].

Fortunately, Div 832 does not interfere with that result.

As currently drafted, the rules in Div 832 seem likely to over-tax a resident earning foreign source income (unless the offshore activities amount to a branch), and to over-tax a non-resident earning Australian source income (if they reside in a foreign tax credit country). We trust this is not the intended outcome but it seems likely in many cases. And the outcomes will likely be capricious: just what ends up happening will depend upon variables such as: do the offshore activities amount to a PE or not; how is double tax relieved in the residence country; does the other country have rules equivalent to Div 832?

Deduction / non-inclusion mismatch. While the general tenor of Div 832 is that the regime focuses exclusively on cross-border transactions, the drafting seems to us to be capable of unintended application to entirely domestic transactions.

One place to see this is s. 46FA. It gives a deduction for the amount of a flow-on dividend paid by a resident company in defined circumstances. If that dividend is received by a company which chooses to apply Div 802 instead of s. 46FA [see s. 802-55] and treat the amount as NANE income under s. 802-20, it seems to us that this fact pattern strictly, but unintentionally, meets the definition in s. 832-920.

It seems to us, therefore, desirable to make a stricter tie in s. 832-920 between –

- paragraph (1)(a)(i) and (1)(b)(i) only; and
- paragraph (1)(a)(ii) and (1)(b)(ii) only.

This would make the cross-border element more clearly necessary for a D/NI outcome, just as it is for a D/D outcome.