The hybrid mismatch rules: impact on foreign investors

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Abstract: The hybrid mismatch legislation contained in the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 received royal assent on 24 August 2018 and applies to income years starting on or after 1 January 2019. On 21 June 2018, the ATO released a draft practical compliance guideline (PCG 2018/D4) which considers the application of the general anti-avoidance rules contained in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) in relation to restructures that occur in order to comply with the hybrid mismatch rules. This article focuses on certain aspects of the application of the hybrid mismatch rules on inbound investments. The authors are of the view that foreign investors should consider the potential impact of the hybrid mismatch rules sooner rather than later. It is expected that the identification of potential hybrid mismatches may not be straightforward, particularly as there are some uncertainties regarding key concepts in the legislation and explanatory memorandum, and the knowledge required on the upstream structure and the relevant overseas tax laws.

Introduction

The hybrid mismatch legislation contained in Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 received royal assent on 24 August 2018. The rules will apply to income years starting on or after 1 January 2019. However, other than where an importing payment is made under a structured arrangement, the imported mismatch rule will only apply to income years starting on or after 1 January 2020. This article focuses on certain aspects of the application of the hybrid mismatch rules on inbound investments.

The hybrid mismatch rules intend to eliminate hybrid mismatches that arise from the differences in the tax treatment of an entity or financial instrument in two or more jurisdictions by disallowing a deduction or including an amount in assessable income. The rules also incorporate a unilateral "integrity rule" to discourage the interposition of entities in zero or low tax rate jurisdictions.

Further, on 21 June 2018, the Australian Taxation Office (ATO) released a draft practical compliance guideline (PCG 2018/D4) which considers the application of the general anti-avoidance rules contained in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) in relation to restructures that occur in order to comply with the hybrid mismatch rules.

The authors have found that the hybrid mismatch rules may have application in some unexpected circumstances where the outcomes may be unintended. It appears that the rules have been drafted on the basis that each taxpayer (and its tax manager) has detailed knowledge of the investment structures, as well as an intimate knowledge of the foreign tax rules applicable to the relevant structure. In the authors' experience, this is rarely the case in practice, which creates practical challenges for taxpayers in considering the application of the hybrid mismatch rules and significant compliance costs for investors into Australia.

Taxpayers will note that the international dealings schedule for the 2018 year includes a couple of questions in relation to investment in, and income or expenses in relation to, a hybrid entity. It is expected that additional questions in relation to hybrid mismatches will be added onto the international dealings schedule form in future years, which require taxpayers to consider the application of the hybrid mismatch rules to their structures when fulfilling their income tax compliance obligations.

Foreign investors will need to review their investment structures in light of the hybrid mismatch rules. In particular, inbound investors investing through trusts or transparent entities, or through entities in low tax jurisdictions should consider the application of these rules.

Key concepts of the hybrid mismatch rules

To determine whether the hybrid mismatch rules apply to a structure, taxpayers must consider whether one of the six types of hybrid mismatches (ie hybrid financial instrument, hybrid payer, reverse hybrid, branch hybrid, deducting hybrid and imported hybrid) is present. This assessment requires consideration of whether there is a payment that gives rise to either a deduction/non-inclusion (DNI) mismatch or a deduction/deduction (DD) mismatch.

Relevant concepts in determining whether payments give rise to a DNI or a DD mismatch include whether amounts are "subject to foreign income tax" or "foreign income tax deductions".

Where there is a hybrid payer or a deducting hybrid mismatch, the hybrid mismatch amount would be reduced to the extent there is available dual inclusion income.

Subject to foreign income tax

An amount of income or profits is considered subject to foreign tax if foreign income tax is payable on the amount because it is included in the tax base of the relevant entity under the law of a foreign country.

The rules are clear that in most circumstances, an amount would be regarded as being subject to tax even if an entity's tax base is nil or a negative amount as a result of applying certain deductions, losses or credits. However, where an entity is entitled to receive a credit, rebate or other tax concession for foreign tax (other than a withholding-type tax), only the

pre-credit amount that is not sheltered by the credit, rebate or other tax concession would be regarded as subject to foreign income tax. In addition, where an entity is entitled to a foreign income tax deduction in respect of all or part of the dividend that it receives, only so much of the dividend which is not effectively sheltered from foreign income tax by the foreign income tax deduction would be regarded as subject to foreign income tax. Further clarification is provided in the explanatory memorandum (EM) to the hybrid mismatch rules, whereby an amount would not be treated as being subject to foreign tax if:

- the foreign law does not impose tax on the type of payment (such as a territorial regime that exempts foreign source income, as may, for example, be the case under Singapore or Hong Kong tax law); or
- a foreign law subjects the type of payment to a tax rate of 0%.

It is unclear whether the term "the type of payment" in this context should be interpreted broadly or narrowly. How the term is interpreted would, for example, determine whether the rule captures an interest payment made by an Australian entity to a Singaporean entity's Hong Kong bank account that is not taxed in Singapore as it is not remitted (or deemed remitted) into Singapore.

If the term "type of payment" is interpreted as "any payment from a foreign source that is not remitted to Singapore", the interest payment would seem to be regarded as not being subject to foreign income tax. However, if the term is interpreted to refer to the specific type of payment, being an "interest payment", the comment in the EM is not necessarily satisfied as Singapore principally imposes tax on interest payments received.

As a general observation, payments made to an entity located in a zero tax rate jurisdiction (eg British Virgin Islands), a no tax jurisdiction (eg Cayman Islands, Bermuda) and, depending on circumstances, territorial regime jurisdictions (eg Hong Kong, Singapore) may be regarded as not being subject to foreign income tax and may therefore give rise to a DNI mismatch.

However, it is important to note that even if a payment is not subject to foreign income tax and gives rise to a DNI mismatch, a type of hybrid mismatch must be present for the hybrid mismatch rules to apply.

Example 1.6 in the EM illustrates the case of a dividend on a redeemable preference share, which is deductible for Australian tax purposes and is paid by an Australian company to a foreign limited partnership. The foreign limited partnership is treated as a transparent entity overseas and the dividend paid to the foreign limited partnership would be regarded as not being subject to foreign income tax as the partners in the limited partnership are exempt pension funds. Nonetheless, there would only be an implication under the hybrid financial instrument mismatch rules if the DNI mismatch is attributable to differences in the classification of the financial instrument (eg debt or equity) in two jurisdictions, having regard to the term of the instrument.

> *"The hybrid mismatch rules may have application in some unexpected circumstances where the outcomes may be unintended."*

Foreign income tax deduction

In an inbound investment context, one may also have to consider whether a payment gives rise to a foreign income tax deduction, for example, when analysing whether a relevant offshore hybrid mismatch exists for imported hybrid mismatch purposes. An amount is a foreign income tax deduction if the relevant entity is entitled to deduct the amount in working out its tax base under the law of a foreign country, even if that tax base is nil or a negative amount. An amount is taken to have been deducted if it is applied to reduce the amount of tax payable by the entity in the foreign country in any way.

However, unlike the term "subject to foreign income tax" for payments to foreign entities, the EM does not clarify how payments from entities in jurisdictions with zero tax rates would be treated to determine whether an amount gives rise to a "foreign income tax deduction".

The Organisation for Economic Co-operation and Development (OECD) defines "tax base" as being the amount on which the tax rate is applied. Therefore, there is an argument that a payment by an entity located in the British Virgin Islands (a zero tax rate jurisdiction) can be regarded as giving rise to a foreign income tax deduction on the basis that the amount is included in the entity's tax base, albeit a 0% tax rate would apply.

This can be compared to a no tax jurisdiction where no tax base exists, eg Cayman Islands does not have a corporate tax law.

Integrity rule

The hybrid mismatch rules include a targeted integrity rule that shall apply to "financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax".

The introduction of this unilateral tax measure is out of step with the OECD base erosion and profit shifting recommendations in its 2015 report, which stated that: "The recommendations in the report ... are not intended to capture payments made to a person resident in a no-tax jurisdiction".

Broadly, the integrity rule targets arrangements that may be entered into by taxpayers to otherwise circumvent the application of the hybrid mismatch rules, ie using an interposed conduit vehicle to invest into Australia as an alternative to investing directly into Australia via traditional hybrid instruments or entities.

Unlike the six types of hybrid mismatches, the integrity rule is designed to capture interest and derivative payments made by an entity to an interposed foreign entity within the same "Division 832 control group" where the payments are subject to foreign income tax at a rate that is 10% or less, or not subject to foreign income tax (no or low tax outcome). The integrity rule only has regard to the headline tax rate which applies to the relevant payment. It disregards any foreign tax credit or deduction which may reduce the effective tax rate applicable to the relevant payment to a rate of 10% or less.

The rule requires that it must be reasonable to conclude that the scheme is entered into for a principle purpose of, or for more than one principal purpose that includes a purpose of, enabling a deduction and enabling the no or low tax outcome.

The integrity rule applies irrespective of whether there is a hybrid arrangement. In fact, the integrity rule does not apply where a payment gives rise a hybrid mismatch type.

However, the integrity rule would only apply where there is another entity, being the "ultimate parent entity", in the same Division 832 control group structure (discussed below).

An ultimate parent entity is the entity in the control group that is not controlled by any other member of the group.

Where all conditions are satisfied, the integrity measure will deny the Australian deductions, unless it is reasonable to conclude that:

- the payment is included in assessable income under the controlled foreign company rules of Australia or another country;
- assuming the payment had been made directly to the ultimate parent entity, the payment would either be not subject to foreign income tax or subject to foreign income tax at a rate that is the same as, or less than, the interposed country rate; and the payment would not give rise to a hybrid financial instrument mismatch, a hybrid payer mismatch or a reverse hybrid mismatch; and
- the scheme was not designed to produce an Australian income tax deduction and the imposition of foreign income tax on the payment at a rate of 10% or less.

Where there is an arrangement involving back-to-back loans or another back-to-back arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans, the original payer will be deemed to have made the payment directly to the top entity in the back-to-back arrangement.

Division 832 control group

Broadly, entities are in the same Division 832 control group if they are members of an accounting consolidated group, or where one entity holds a direct or indirect interest of 50% or more in the other entity, or an interest of 50% or more in the relevant entities is directly or indirectly held by a common holder. This concept, as noted above, is relevant for the purposes of determining the application of both the hybrid mismatch rules and the integrity rule.

Taxpayers will need to understand, among other things: (1) which entities are included in the accounting consolidated group; and (2) the upstream structure to be able to identify the ultimate parent entity.

In particular, this could pose a challenge for consortiums where the consortium pooling vehicle is in a Division 832 control group with one of the consortium members (either due to accounting consolidation or 50% or more ownership). This is because the Division 832 control group would capture the consortium member's own ownership structure and, therefore, the identification of the ultimate parent entity would require an examination of that member's upstream ownership structure.

Further, in the context of a consortium, a hybrid arrangement between the consortium pooling vehicle and a consortium member within a Division 832 control group would have a broader implication as the after-tax return received by the other consortium members may still be impacted. For example, if an interest deduction is disallowed on a payment made by the Australian pooling vehicle to the consortium member within a Division 832 control group, all consortium members would bear the additional Australian tax borne by the Australian pooling vehicle based on their proportionate ownership interest.

Further, as one of the exclusions to the integrity measures requires the comparison of the income tax rate payable in the interposed foreign country to the rate that would apply had the payment been made to the ultimate parent entity and that this notional payment to the ultimate parent would not give rise to certain hybrid mismatches, taxpayers may need to carefully consider the location and form of their ultimate parent entity going forward as it may impact the outcome of whether the integrity measure would apply to their structure.

Restructure of existing investments

In almost all cases, simply allowing the hybrid mismatch rules to apply to existing arrangements will not be a viable option for various reasons (eg the risk of withholding tax on non-deductible interest, impact on thin capitalisation and transfer pricing). Therefore, taxpayers with hybrid mismatches will need to consider their options, which are likely to involve restructuring to comply with the rules in order to remove adverse outcomes.

The ATO released its draft practical compliance guideline providing guidance on its compliance approach to the application of Pt IVA to restructures that have the effect of preserving Australian tax benefits (eg Australian interest deductions) that would otherwise be disallowed under the hybrid mismatch rules.

According to the draft guideline, provided the taxpayer has engaged in ordinary commercial dealings to restructure its arrangement to remove the hybrid mismatch and preserve the Australian tax benefit, the ATO may consider the arrangement to be low risk and the Commissioner would not seek to apply Pt IVA.

The draft guideline identifies six assumptions, all of which must apply for a restructure to be considered low risk:

- there is no change to the jurisdictions of the entities involved under the replacement arrangement;
- the original arrangement makes commercial sense for the parties involved (ie prior to the restructure, it would not have attracted the application of Pt IVA);
- the replacement arrangement makes commercial sense for the parties involved;
- the restructure and replacement arrangement are effected in a straightforward way, having regard to the circumstances;
- the restructure and replacement arrangement are implemented on arm's length terms; and
- the replacement arrangement is otherwise tax effective (ie a tax benefit is preserved).

The information on a taxpayer's arrangements and restructures may be required to be disclosed in the reportable tax position schedule of the tax return.

The draft guideline will become effective from the date of enactment of the hybrid mismatch rules and will apply to restructuring arrangements entered into before and after that date.

Conclusion

Foreign investors should consider the potential impact of the hybrid mismatch rules sooner rather than later. This will include the identification of any entities in the structures that are located in zero tax, no tax or territorial tax regimes, as well as those which are subject to concessional tax treatments.

Consortiums may also need to examine their structures to identify the extent of their Division 832 control group in

assessing the potential application of the rules.

It is expected that the identification of potential hybrid mismatches may not be straightforward, particularly as there are some uncertainties regarding key concepts in the legislation and the EM, and the knowledge required on the upstream structure and the relevant overseas tax laws.

Taxpayers which are considering restructuring out of hybrid arrangements and entering into alternative arrangements that do not attract the operation of hybrid mismatch rules should carefully consider the application of Pt IVA in addition to the legal, accounting, treasury and foreign tax issues pertaining to the new arrangements.

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