

NOVEMBER 2018

TECHNICAL UPDATE



RESTRUCTURE OF HYBRID MISMATCH ARRANGEMENTS AND TAX AVOIDANCE GUIDANCE

THE ATO HAS ISSUED FINAL GUIDANCE TO ASSIST TAXPAYERS TO MANAGE THEIR COMPLIANCE RISK BY OUTLINING STRAIGHTFORWARD LOW RISK RESTRUCTURING TO WHICH THEY WON'T SEEK TO APPLY TAX AVOIDANCE PROVISIONS. TAXPAYERS HAVE A SHORT WINDOW OF OPPORTUNITY TO REVIEW THEIR EXISTING HYBRID ARRANGEMENTS AND TO UNWIND OR RESTRUCTURE OUT OF SUCH ARRANGEMENTS IF THEY SO CHOOSE.

PCG 2018/7

On 25 October 2018, the Australian Taxation Office ("ATO") released its final Practical Compliance Guideline [PCG 2018/7](#) which sets out its compliance approach to Part IVA of the Income Tax Assessment Act 1936 ("Part IVA") and certain restructures that have the effect of preserving Australian tax benefits that would otherwise be disallowed with the enactment of the hybrid mismatch rules in [Treasury Laws Amendment \(Tax Integrity and Other Measures No. 2\) Bill 2018](#) on 24 August 2018.

Such benefits include deductions for a wide range of cross border payments (e.g. related party interest, royalties, rents and payments for service) or generating additional taxable income for Australian taxpayers. The hybrid mismatch rules, which will generally take effect from 1 January 2019, address certain hybrid arrangements that exploit differences in the tax treatment of an entity or financial instrument under the laws of two or more countries, which can result in double non-taxation or long-term tax deferral.

FINAL PCG V DRAFT PCG

The PCG follows an earlier draft PCG 2018/D4 that included general ATO messaging for taxpayers restructuring their hybrid mismatch arrangements to mitigate the risk of ATO attack under Part IVA. PCG 2018/7 is similar to the earlier draft, with some changes and improvements responding to input.

PCG 2018/7 now specifically states that a restructure of a hybrid arrangement would prima facie generate a tax benefit but *"the Commissioner would not seek to apply Part IVA where the restructure merely removes the double non-taxation outcome and the arrangement is itself an ordinary commercial dealing or structure without contrived features that would otherwise attract Part IVA."*

The other major change is that two earlier higher-risk scenarios have been removed from PCG 2018/D4 and three new additional low-risk arrangements (scenarios 5, 6 and 7) take their place in PCG 2018/7. PCG 2018/7 also sets out the factors the ATO would consider in making its risk assessment.

The ATO has released guidance to assist taxpayers to manage their compliance risk by outlining low risk restructuring to which the ATO will not seek to apply Part IVA. With the hybrid mismatch rules taking effect from 1 January 2019, taxpayers should review their structures as soon as possible.

LOW-RISK RESTRUCTURING SCENARIOS

PCG 2018/7 sets out seven restructuring scenarios to which the ATO would not seek to apply Pt IVA:

1. inbound mandatorily redeemable preference shares replaced with a 'ordinary' interest bearing loan;
2. an outbound profit participating loan replaced with ordinary equity;
3. an inbound Australian limited partnership that undergoes an internal reorganization to become a deducting hybrid Australian limited partnership;
4. an outbound general partnership that is refinanced to become a deducting hybrid foreign partnership;
5. changing the entity classification for an Australian hybrid payer from a transparent (disregarded) entity for U.S. tax purposes to a separate regarded (taxable) entity under U.S. Federal income tax law using the U.S. check-the-box rules;
6. refinancing an inbound loan from a foreign reverse hybrid entity with a "ordinary" loan from the parent; and
7. refinancing an inbound loan from a foreign interposed zero or low rate lender with an "ordinary" loan from the parent.

In each of these scenarios, there is a straightforward restructuring which removes the hybrid element of the existing arrangement but maintains the surrounding facts and circumstances.

PCG 2018/7 also notes that the seven scenarios are not an exhaustive list.

LOW RISK FACTORS

Where a restructure falls outside these scenarios, taxpayers are to consider factors when performing a risk assessment. Whilst ideally all of these factors should be present, the ATO accepts that this may not be possible in the taxpayer's particular circumstances.

The five broad conditions for the low risk expectation including the commerciality of the restructure and its arm's-length features are as follows:

1. there is no change to the entities or jurisdictions of the entities involved (other than the removal of an entity whose tax characteristics gave rise to the hybrid outcome)
2. the original arrangement would not have attracted Pt IVA;
3. the replacement arrangement would not attract Pt IVA on a stand-alone basis
4. the restructure and the replacement arrangement are executed in a straightforward manner, explicable only by an objective of eliminating hybrid outcomes
5. both the restructure steps and the replacement arrangement are implemented in a commercial manner reflecting arm's length conditions.

PCG 2018/7 states "*low risk characterization is predicated on the replacement arrangement otherwise being an ordinary commercial dealing. This Guideline has no application to an arrangement that, regardless of the hybrid element, contains features that would otherwise have attracted the application of Part IVA.*"

PCG 2018/7 also explicitly highlights that references throughout the guidance to Part IVA exclude the specific provisions that extend Part IVA to cover the Multinational Anti-Avoidance Law ("MAAL") and the Diverted Profits Tax ("DPT"). It will therefore be necessary to address the DPT and MAAL in relation to any replacement arrangements notwithstanding a "low risk" rating in accordance with PCG 2018/7.

DATE OF EFFECT

Although the Hybrid Mismatch rules apply from 1 January 2019 and PCG 2018/7 is effective from 24 August 2018 (the date of enactment of the hybrid mismatch rules), the guidelines apply to restructuring arrangements entered into before and after that date. There are no transitional rules or grandfathering of existing arrangements.

EARLY ENGAGEMENT AND REPORTING RISK ASSESSMENT

The ATO states in PCG 2018/7 that information around restructures may need to be disclosed in the International Dealing Schedule ("IDS"), Local file - short form (as part of Country by Country reporting) or the Reportable Tax Position ("RTP") Schedule. It is unclear, however, how far back in time taxpayers are expected to apply a self-assessed risk rating to their restructures and it is hoped that the ATO will clarify this in the next iteration of updates to the RTP schedule.

[Category C reportable tax positions](#), which currently contains 21 questions, was last updated on 2 July 2018. Entities that are considering restructuring in a manner not covered by the low-risk scenarios in PCG 2018/7 are encouraged to engage with the ATO about their proposed restructure.

General enquiries can be sent to the ATO at: HybridMismatches@ato.gov.au. On 31 October 2018 the ATO advised on their [website](#) that they are currently working on a range of guidance products which will provide further support to those potentially impacted by the hybrid mismatch rules.

IMPORTANT CONSIDERATIONS

The views expressed in PCG 2018/D4 may provide reassurance for some taxpayers that are able to restructure in a manner that satisfies all of the assumptions required to qualify as a low risk restructure and help taxpayers manage their compliance risk by outlining straightforward (low risk) restructuring to which we won't seek to apply Part IVA.

It is important to note, however, that a restructure may not satisfy all the requirements to be considered "low risk" and in such circumstances taxpayers will need to consider the potential application of Part IVA to their arrangements to ensure that there is sufficient evidence to discharge the taxpayer's burden of proof.

Taxpayers should also note that PCG 2018/7 does not cover all issues relevant to restructures of hybrid mismatches, for example thin capitalization outcomes. PCG 2018/7 does however confirm that ATO is willing to deal directly with taxpayers about their restructures if they wish to have direct ATO interaction.

BDO COMMENT

With the hybrid mismatch rules on the verge of taking effect, Australian taxpayers with cross-border transactions should contact BDO for assistance with:

- ▶ Reviewing application of the hybrid mismatch rules to structures including implementation of strategies to either restructure (which will require careful consideration of legal, accounting, treasury and foreign tax issue) or unwind impacted hybrid structures
- ▶ Restructuring out of hybrid arrangements and enter into alternative arrangements that do not attract the operation of hybrid mismatch rules, which is not simple, and requires careful planning and consideration across various areas including legal, accounting, treasury and foreign tax issues
- ▶ Managing these issues which may involve significant lead times if tax, legal and accounting are not aligned as timing will be tight given the wide range of complexities involved and start date of 1 January 2019.



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BNE 0963/1118