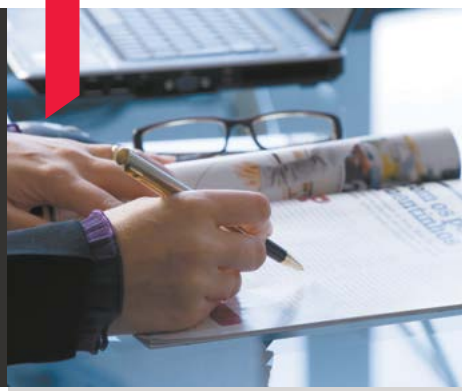
JULY 2018

TECHNICAL UPDATE



UPDATE ON AUSTRALIAN ADOPTION OF HYBRID MISMATCH ARRANGEMENTS

LEGISLATION WAS INTRODUCED INTO THE AUSTRALIAN SENATE ON 27 JUNE 2018 TO IMPLEMENT THE OCED'S BEPS ACTION 2 - NEUTRALISING THE EFFECT OF HYBRID MISMATCH ARRANGEMENTS. THE ATO ALSO RELEASED GUIDANCE ON ANTI-AVOIDANCE PROVISIONS AND RESTRUCTURES OF HYBRID MISMATCH ARRANGEMENTS ON 25 JUNE 2018.

LEGISLATION

Background

Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 (the Bill) was introduced into the Australian Senate on 27 June 2018 and seeks to implement the Organisation of Economic Co-operation and Development's (OECD's) BEPS Action 2 *Neutralising the Effect of Hybrid Mismatch Arrangements*. This Bill updates the previously released exposure drafts (draft law) on 7 March 2018 (as outlined in this BDO Tax Technical Update) and 24 November 2017 (as outlined in this BDO Tax Technical Update) and incorporates rules to address branch mismatch arrangements and introduce a unilateral 'integrity rule' to discourage foreign interposed zero or low tax rate entities lending to Australia. A 'hybrid mismatch' arises if double non-taxation results from the exploitation of differences in the tax treatment of an entity or financial instrument under the laws of two or more countries. Double non-taxation occurs if a deductible payment is not included in a tax base (non-inclusion mismatch), or if a payment gives rise to two deductions (deduction mismatch).

Policy intention

Schedules 1 and 2 to the Bill implement the OECD hybrid mismatch rules that prevent multinational companies from gaining an unfair tax advantage due to differences in the tax treatment of a particular instrument or entity between jurisdictions. The rules also include an integrity rule which will apply where a taxpayer attempts to circumvent the hybrid mismatch rules by routing funds through foreign interposed entities with the aim of gaining an Australian income tax deduction and deliberately avoiding those hybrid mismatch rules. The hybrid mismatch rules build upon previous action by the Australian Government in recent years to address tax avoidance, including the introduction of stronger Transfer Pricing rules, the Multinational Anti-Avoidance Law and the Diverted Profits Tax (DPT). The Government has also increased penalties for companies that fail to take reasonable care when making statements to the ATO and has expanded the ATO's capacity, through the tax avoidance task force.

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What's changed

In comparison to the draft law in March 2018, there have not been substantive changes, however, there has been a change to the integrity measure that applies where Australia makes a deductible interest (or equivalent) payment to an entity in a jurisdiction interposed between Australia and the ultimate parent jurisdiction. In the latest version of the draft law, for the rule to apply, the entity in the interposed jurisdiction was required to be subject to a tax rate of 10% or less. Under the Bill, this test has been changed to require that the payment is subject to foreign income tax in one or more foreign countries and the highest rate at which the payment is subject to foreign tax is 10% or less.

Previously the law had a carve-out where it was not reasonable to conclude that the scheme was designed to produce an Australian deduction and a 10% or less foreign tax rate. Under the Bill, the "design test" has been replaced with a "principal purpose" test. It is now a condition for the integrity rule to apply that the scheme was entered into for a principal purpose or for more than one principal purpose that includes a purpose of obtaining an Australian deduction and enabling foreign tax to be imposed on the payment at a rate of 10% or less. In considering the application of the principal purpose test, the Bill specifically requires consideration to be given to the source of funds provided by the interposed foreign entity to Australia and whether the interposed foreign entity engages in substantial commercial activities in carrying on a banking, financial or other similar business.

The Bill contains also changes to the mechanics dealing with the ability of foreign bank branches to obtain a notional deduction, the treatment of deductions that arise in different periods to when the payment is made and the interaction of the hybrid mismatch rules with various part of the existing taxation law including the Taxation of Financial Arrangements provisions, trading stock provisions, capital gains tax provisions, partnership and trust provisions, controlled foreign company provisions and foreign currency translation rules. Unlike the DPT, there is no carve out for collective investment, sovereign wealth or widely held entities.

The start date of the imported mismatch provisions in Div 832 H has been also delayed by one year to apply to assessments for income years starting on or after 1 January 2020. These provisions are aimed at stopping arrangements that seek to avoid the application of the hybrid mismatch rules by interposing one or more entities between the hybrid mismatch and a country that has hybrid mismatch rules by reducing or eliminating tax deductions for payments made by an Australian company which directly or indirectly fund a hybrid mismatch outcome in any country that has not adopted OECD hybrid mismatch rules. The exception to this is where the imported mismatch payment i.e. the payment giving rise to the Australian deduction is made under a 'structured arrangement' where the hybrid mismatch is priced into its terms or it is reasonable to conclude that the scheme has been designed to produce a hybrid mismatch.

Start date

Between announcing this measure and introducing the Bill into Parliament, the Government missed its originally proposed implementation date of 1 July 2018 and the start date is now 1 July 2019. Consistent with the draft law in March 2018, there is no grandfathering of existing arrangements.

Taxpayers will need to review their existing arrangements to determine if the extended application date will apply. It is expected that the law will be enacted later this year after Parliament, which is currently in a Winter recess until 13 August 2018, resumes.

ATO GUIDANCE

Overview of PCG 2018/D4

On 21 June 2018, the Australian Taxation Office (ATO) released draft Practical Compliance Guideline PCG 2018/D4 which provides draft guidance as to how the ATO may apply Australia's general anti-avoidance rules in Part IVA of the Income Tax Assessment Act 1936 (Part IVA) to restructures which seek to reverse the tax benefit that the hybrid mismatch rules see to neutralise. The stated purpose of PCG 2018/D4 is to allow taxpayers to manage their compliance risk by illustrating various straight forward scenarios to confirm the type of restructures which may generally be considered 'low risk' by the ATO from a Part IVA perspective. BDO support the Government to be upfront about the compliance risks when restructuring an existing hybrid mismatch arrangement to avoid new rules that target them. The guidance assumes the new rules—currently before parliament within a broader bill—will be passed into law. The draft PCG is split into the following three sections – 1) The ATO's compliance approach to Part IVA and arrangements that are restructured to address hybrid mismatches, 2) Identification of 'low risk' scenarios and associated examples, and 3) Examples of 'higher risk' scenarios that will not preclude scrutiny of the arrangement if it is one that otherwise has features of artificiality or contrivance.

ATO's compliance approach to Part IVA and restructures to address hybrid mismatches

The draft PCG highlights that restructures which result in the elimination of a hybrid mismatch and the preservation of an Australian tax benefit may not attract the operation of Part IVA. Instead, the ATO will consider whether the arrangements should be considered 'ordinary commercial dealings' of the taxpayer. The ATO also states that there is an expectation that where there is the elimination of a hybrid mismatch which results in the preservation of the Australian tax outcomes, that the 'tax benefits in the foreign counterparty jurisdiction will no longer be available'. The ATO also takes the position that it should not be assumed that a restructure in anticipation of the hybrid mismatch rules cannot be subject to Part IVA. In particular, PCG 2018/D4 states this may be the case where parts of the relevant scheme continue to be carried out or are given effect after the enactment of the hybrid mismatch rules.

Low-risk restructures

The ATO considers a low-risk restructure would involve removing the hybrid feature of the structure while keeping all associated facts and circumstances unchanged. In this regard, the ATO is focused on the overall commerciality of the arrangement rather than the technical existence of the tax benefit itself. The hybrid feature may be removed, for example, in the context of a deduction/non-inclusion mismatch where income is included in the tax base of an entity or, in the context of a deduction/deduction mismatch, where there is no longer a deduction available in one of the jurisdictions.

The following features have been identified in PCG 2018/D4 as being consistent with low-risk restructures:

- 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 (prior to the restructure it would not have attracted Part 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 and are implemented on arm's-length terms
- The replacement arrangement is otherwise tax effective, disregarding the potential application of Part IVA, to preserve a tax benefit.

PCG 2018/D4 also provides four examples of restructures that satisfy these assumptions, and are therefore considered to be low risk:

1. Replacement of inbound hybrid preference shares with interest bearing debt
2. Replacement of an outbound hybrid profit performing loan with ordinary equity
3. Reorganisation of the ownership of an inbound Australian limited partnership
4. Refinancing an outbound general partnership.

High-risk restructures

Two examples are provided in PCG 2018/D4 of arrangements that, whilst removing the hybrid element of the arrangement, may nonetheless attract the application of Part IVA.
These include:

1. Cross-border round robin financing arrangements whereby there is removal of a hybrid mismatch that previously produced a foreign income tax deduction but, due to accumulated losses in a foreign company, the new arrangement results in the same foreign (and Australian) tax outcome
2. Conduit financing via a low tax jurisdiction where there is the interposition of a third company which is a resident in a low tax country i.e. with a 'substantially lower rate' of corporate tax as compared to the original lender and Australia).

PCG 2018/D4 reminds taxpayers that a ruling could be obtained in relation to restructures that are not covered by the low risk scenarios and notes that some taxpayers may be required to disclose information about hybrid arrangements or any restructures in the Reportable Tax Positions schedule.

A more proactive ATO

PCG 2018/D4 follows the release of this year's International Dealings Schedule (IDS) on 12 June 2018, where companies with international dealings of more than A$2 million ($1.5 million) with related parties during the 2018 tax year are required to be lodge with 2018 returns. The ATO said that if a company answers "yes" to any of the questions asking whether it had any hybrid mismatch arrangements in place during the 2018 income tax year, it must also specify the amount of affected income. PCG 2018/D4 and new questions on the same topic in this year's IDS is evidence of the ATO becoming more proactive and an obvious change due to more senior people with Professional Services experience employed in senior positions at the ATO. Although it is unusual for the ATO to be issuing guidance on the application of Part IVA, hybrid mismatch guideline is an example of the ATO's new tactic to talk tough in terms of risk. Instead of delineating an arrangement as coming within the ambit of Part IVA, for example, the guidance is in terms of "high risk" or "low risk" — less definitive but still of practical benefit.

BDO COMMENT

PCG 2018/D4 will be effective from the date of enactment of the hybrid mismatch rules, however, it will apply to restructures entered into before and after the date of enactment. "The enactment of the rules with a deferred date of commencement is intended to allow taxpayers time to review their existing hybrid arrangements and to unwind or restructure out of such arrangements in advance of the rules if they so choose," the ATO said in its guidance. Some multinational companies will consider restructuring their hybrid mismatch arrangements before the new rules are enacted and then seek to rely on the Federal Court's 1998 decision in CPH Property Pty Ltd & Ors v Commissioner of Taxation [1998] FCA 1276 (13 October 1998), which broadly held that Part IVA couldn't apply to a restructure carried out before relevant tax amendments were enacted. It seems though the ATO is alert to this possibility. In its guidance, it warns that "it should not be assumed" such an action will not be subject to scrutiny, "particularly where such arrangements continue to be carried out and given effect after enactment."

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, however it also does little more than provide support for the existing assumption that "vanilla" restructures should not attract the focus of the ATO. It would have been beneficial have examples with different Australian tax outcomes.

For taxpayers that have any element of additional complexity to restructure arrangements, the PCG provides limited practical reference points and therefore the restructure arrangement is likely to require substantial analysis to properly assess the Part IVA risk. PCG 2018/D4 is not intended to provide detailed technical Part IVA guidance, makes a number of assumptions without any explanation and includes examples with only minimal facts, therefore a detailed analysis of the application of Part IVA to a taxpayer's circumstances or separate engagement with the ATO may still be required.

With the hybrid mismatch rules legislation also on the verge of enactment, 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 entering 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 July 2019.

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