Ms Karen Payne
Chair, Anti-Hybrids Board of Taxation working group
Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

15 January 2016

By email: hybrids@taxboard.gov.au

Dear Ms Payne,

Implementation of the OECD anti-hybrid rules

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission to the Board of Taxation (the **Board**) in relation to the Implementation of the OECD anti-hybrid rules consultation paper (the **consultation paper**) released for comment on 20 November 2015.

Executive Summary

- We consider that detailed modelling is required by Treasury in advance of any decision to ensure that the economic impact of introducing the OECD recommended anti-hybrid rules is understood and is consistent with clearly articulated policy aims. The effect of various approaches on the cost of capital for Australian taxpayers, including possible sectoral consequences should be estimated, drawing on both modelling and dedicated consultation with affected businesses. We consider it necessary to understand the effects these rules will have on the relative competitiveness of our tax system and accordingly the long term impact on our economy. PwC have been advocates for reform of Australia's international tax rules through balanced measures which attract global capital, incentivise growth and disqualify inappropriate advantages in a fair manner.

- We are concerned that the complex nature of the proposed rules and their interaction with domestic laws and other anti-hybrid laws globally will lead to significantly increased

compliance costs for both taxpayers and tax administrators. To address this, we recommend consideration be given to the introduction of an appropriate de minimis rule and a motive (purpose) test. We also recommend consideration be given to exempting transactions between genuine third parties, or non-'related' parties, from the anti-hybrid rules altogether.

- Careful consideration should also be given to the interaction with Australian domestic laws and international rule coordination to ensure there is no double taxation and the number of disputes with tax administrators across the globe does not exponentially increase. There is a risk that jurisdictions may introduce rules that do not accord with the way in which other jurisdictions interpret the recommendations (an example is provided below).

- The OECD's anti-hybrid rules will only be effective if they are implemented by all, or a large majority of, jurisdictions which participated in the base erosion and profit shifting (**BEPS**) project. To date, we are aware of only one country, the UK, committing to legislate the rules in full. Given the considerable complexity of the issues involved, other national responses can be expected to take some time. In these circumstances, premature action by Australia would impose economic costs (as deductions may be denied for Australians) without any commensurate global integrity benefit. Ideally, any rules we develop should not come into effect until the majority of our trading and investment partners have committed to action.

Detailed comments

Economic assessment and modelling (questions 1 and 2)

PwC have been advocates of the OECD BEPS process. At the same time, PwC has been very strong and clear in its message that international tax reform is long overdue.

We need an international tax system that is fair, efficient and simple. A tax system that appropriately encourages investment and growth and disqualifies the obtaining of inappropriate advantages. A tax system that is modern and competitive in attracting global capital that does not detract from the incentives Australian entities have to remain domiciled here, recover an appropriate return from both inbound and outbound investment, and further the competitiveness of our economy generally.[1]

[1] Highlighted in the Commonwealth of Australia 1999, Review of Business Taxation: A tax system redesigned, July 1999, Commonwealth of Australia, Canberra. The Board also acknowledged in its 2014 discussion paper on the debt and equity tax rules, that foreign investment provides additional capital for economic growth, creation of new employment opportunities, improvement of consumer choice and promotion of competition.

The Government announced its intention to review the Australian taxation system, including the competitiveness of our business tax arrangements as part of the Tax White Paper process. The Government's approach to hybrids, and other OECD recommendations, should be consistent with, and informed by, the finding of this review.

We believe that tax reform, including any implementation of OECD recommendations, should not be developed in a piecemeal manner, rather, initiatives should be informed by a clear medium-term policy framework which recognises the need to attract investment given Australia's position as a capital importer; avoids excessive compliance burdens and uncertainty for taxpayers; and addresses integrity concerns in a targeted, proportionate and effective manner, minimising collateral economic damage.

Poorly conceived action on hybrids, given the complexity of the issue, the far-reaching interactions with domestic law and the uncertain nature of other jurisdictions' responses, could be highly costly, in economic and compliance burden terms. Detailed modelling of the primary and secondary impacts should be undertaken to ensure that the anticipated outcomes are consistent with policy aims.

The adoption of global international tax measures in isolation, without consideration of a balanced approach to Australian tax reform, means that Australia will be relatively less attractive. This could be detrimental to the Australian economy, impacting decisions on foreign direct investment and potentially encouraging Australian business to seek access to capital overseas by relocating their business.

Australia has a strong armoury of rules already in place to counter BEPS. Recently, there have been a number of reforms that focus on integrity and transparency measures that add to this armoury, including: a multinational anti-avoidance rule which came into effect from 1 January 2016; recently tightened thin capitalisation rules to limit excessive debt in Australia; further strengthening of both our transfer pricing rules and our general anti-avoidance rule in Part IVA; adoption of the OECD recommended country by country reporting; public disclosures of taxpayer information, and; measures which require taxpayers to lodge accounts. Additionally, the Australian CFC regime is amongst the strictest globally. Unlike other jurisdictions, Australia comes to this issue from a strong starting point and this should not be underestimated.

Whilst we support the objects of action 2 and the elimination of double non-taxation, we recommend that the impacts are modelled and any potential detriment is balanced by consideration of a package of measures. As an overriding principle, the elimination of double non-taxation should not be at the cost of double taxation as this would be detrimental to global commerce. We also consider the mitigation of significant compliance burdens on taxpayers and administrations to be paramount.

Clearly, since the proposed rules are highly complex and involve alignment with domestic and other laws, there are likely to be many more issues than we have identified in the short time available. It is likely that these are best addressed once detailed law has been developed. Assuming implementation of the OECD's recommended rules proceed, we recommend extensive consultation on the specific implications and interactions of the proposed law.

Double taxation and rule coordination

A significant compliance burden imposed on taxpayers (and administrators) will be the need to understand, in detail, the application of tax rules in every other jurisdiction, and the need for the rules to be implemented and interpreted consistently. Absent coherence, anti-hybrid rules could create instances of double taxation which would result in a negative economic impact.

Example 1 in Appendix B of the consultation paper illustrates how the anti-hybrid rules may apply to an Australian limited partnership (**Aust LP**) arrangement that pays interest to UK corporate partners. The analysis provided states that, from a UK perspective, "the interest income and interest expense is disregarded as the Aust LP is transparent for tax purposes." The example concludes that, since the interest expense incurred by the Aust LP is deductible in Australia but the interest income is disregarded in UK Co 1 and UK Co 2, this gives rise to a D/NI outcome. Recommendation 3 (disregarded payments rule) therefore applies to disallow the deduction arising to Aust LP under the primary rule.

However, for UK tax purposes, the income and expense of Aust LP is not disregarded. Rather, the loans issued by Aust LP are recognised and deductions for the interest expense are allocated to UK Co 1 and UK Co 2.

In accordance with the UK exposure draft legislation released in December 2015, it is likely that the deduction arising to UK Co 1 and UK Co 2 would be denied. This is consistent with OECD recommendation 6, deductible hybrid payments rule (and not recommendation 3).

Therefore, the analysis provided in example 1 resulting in a denial of the deduction for interest expense in Australia would effectively result in double taxation as the expense would also be denied in the UK. This demonstrates the complexity of the rules and difficulty in their administration.

There are also likely to be features of Australian law which cause uncertainty in applying rules implemented in foreign jurisdictions based on the OECD's recommendations. The Australian tax consolidation rules have often created confusion when considered in accordance with foreign law concepts. For example, income received by a subsidiary member of a consolidated group is not taxed by that subsidiary but instead by the head company of the group in accordance with the single enterprise principle. Whilst the income is clearly subject to tax, a foreign analysis of the

rules may treat the payee as not including amounts in its ordinary income and deny a deduction to the payer. This may result in double taxation.

Interaction with Australia's tax laws (question 4)

The anti-hybrid rules are complex and, in the absence of exposure draft law, it is not possible to identify all potential conflicts that may arise. With this in mind, we anticipate:

- Interaction issues with the CFC rules. Our CFC rules are arguably one of the most complex areas of the domestic tax law. In the past, Australia has chosen not to incorporate domestic legislation into the CFC rules (for example, the TOFA rules and the debt and equity rules were not incorporated into the CFC rules) largely because of the associated compliance burden.

  The OECD recommends countries amend their existing CFC rules to ensure ordinary income allocated to a taxpayer by a reverse hybrid is attributed and subject to tax (to eliminate any non-inclusion outcome). We consider that our domestic CFC rules are quite comprehensive and already meet the OECD best practice guidelines (per action item 3).[2]

  Furthermore, as noted above, CFC reform was announced in the 2009-10 Federal Budget and exposure draft legislation released by the Government in 2010, to "modernise" the regime, reduce the compliance burden, and ensure that our foreign source rules were competitive internationally. The CFC reform was subsequently abandoned in December 2013.[3] PwC does not recommend piecemeal changes be made to the existing CFC rules without broader consideration of reform in line with the 2009-10 announcement.

- Interaction issues with the thin capitalisation and withholding tax rules. We recommend consideration be given to the secondary effects of denying tax deductions or switching off the participation exemption on hybrid arrangements. For example, consideration should be given to whether (a) interest withholding tax (**WHT**) should still apply to interest payments made on non-deductible hybrid debt arrangements, (b) whether the hybrid arrangement should be re-characterised for thin capitalisation purposes (that is, should a non-deductible loan still be included as debt or as a non-debt liability, and should taxable equity interests still be included as controlled foreign entity equity) and (c) whether and how the taxation of foreign exchange gains and losses will be affected by a hybrid characterisation.

- Statutory interpretation issues with the ordering of existing rules. We recommend that consideration be given to the interaction and ordering of any anti-hybrid rule with other

[2] As acknowledged by the Hon. Scott Morrison MP, Treasurer, in a press release dated 5 October 2015.
[3] As announced by Arthur Sinodinos, former Assistant Treasurer, in a media release dated 14 October 2013.

"priority" integrity rules such as the general anti-avoidance rule in Part IVA, the transfer pricing rules in Division 815, thin capitalisation and withholding tax provisions. An ordering rule along with detailed guidance should be developed outlining which rules take precedence in situations where overlap may exist. Without this, uncertainty and increased compliance costs for both taxpayers and the tax administrator will arise.

Concerns regarding increased compliance costs (question 2)

One of the difficulties in applying the recommended anti-hybrid rules is that they require a detailed understanding of the tax law in each counterparty jurisdiction.

For example, with regard to hybrid financial instruments, the rules require taxpayers to understand in the counterparty jurisdiction the ordinary tax treatment of a payment; whether the deduction would be denied or participation exemption switched off; and anticipate the future tax treatment of the payment to determine whether the mismatch is purely a timing difference. This will require a substantial amount of technical analysis and will increase the cost of compliance.

Whilst it may be reasonable to assume in a related party context that information is easily attainable, in reality this is not always the case. Having to obtain information on every transaction across multiple jurisdictions will increase the cost of compliance significantly. Taxpayers will have greater difficulty obtaining this information in unrelated circumstances. For example, information reporting required to inform the issuer of tax profiles of unrelated holders or to inform holders of the issuer's tax position; and the need to regularly update this information are just some examples of difficulties we anticipate taxpayers will experience.

For these reasons, we recommend consideration be given to the implementation of a de minimis threshold or a motive (purpose) test (or both) to reduce the compliance and administrative burden. This would also be consistent with an overarching policy objective of tackling aggressive tax planning.

With regard to the former, there is already precedent in our tax law where de minimis thresholds have been used to minimise compliance costs. For example, the thin capitalisation rules, the recently introduced MAAL and the TOFA rules. With regard to the latter, we acknowledge that the OECD recommendations generally apply to structured arrangements which require evidence of a design or economic advantages to be shared amongst the participants, however, we have experienced difficulties with 'design' thresholds before. Taxpayers are far more familiar with purpose based tests.

Consideration may even be given to exempting transactions between genuine third parties, or non-'related' parties, from the anti-hybrid rules altogether.

Whilst, we acknowledge that the OECD recommend against a purpose test, suggesting that the rules should be applied automatically, we consider that this should be weighed against the anticipated costs.

In the case of imported mismatches and even reverse hybrids, taxpayers will need to understand the tax treatment of payments in the hands of parties other than those with whom they are directly transacting. Equally, to administer these rules, tax authorities throughout the globe will need to have a complete understanding of the respective tax treatment for each entity in a wider chain of entities involved, including aspects that otherwise have no direct impacts or consequences from an Australian revenue perspective. Based on the OECD recommended principles, and the analogous UK draft legislation released in December 2015, the imported mismatch rule contains design thresholds which will make the rule extremely difficult to comply with and administer.

As noted above, we have had difficulty in the past applying rules that rely on design thresholds. The most recent example is section 974-80. For the better part of a decade, interpretational issues associated with section 974-80 were the subject of considerable commentary, debate and consultation culminating with the Government's April 2015 announcement, at the Board's recommendation, that it will repeal the rules due to the uncertainty and significant practical difficulties created for taxpayers and the tax administrator.

In addition, the imported mismatch rules require tracing of funding arrangements between chains of entities. There is a significant body of case law in Australia that illustrates the practical difficulties associated with tracing and apportionment. For example, there have been difficulties in the past where the source and application of funds was not clear. The ongoing need for judicial interpretation was a contributing factor to the introduction of section 25-90, the policy of which was to reduce the cost of compliance.

In light of these factors, consideration should be given as to whether Australia needs to implement the imported mismatch rule. If the imported mismatch rule is considered necessary, we strongly recommend consideration be given to simplifying and limiting its application to identified schemes that are part of a single arrangement and that have direct correlation. In line with our comments above, the imported mismatch rule would also benefit from the adoption of purpose based test as opposed to design thresholds.

Implementation timing and transition (questions 6 to 8)

PwC are of the strong view that the timing of implementation should be coordinated with other OECD jurisdictions and, if necessary, deferred until the majority of our main trading partners have implemented the anti-hybrid rules. We consider there to be little advantage for Australia being an early adopter and acting unilaterally (which is also contrary to the OECD recommendations) let alone without thorough analysis of the impact for our economy.

We also consider there to be little benefit of expediting implementation when there is a broader review of the Australian taxation system being undertaken, which includes a review of the international tax system. Businesses value certainty and stability, and legislative amendments that are unsupported by economic rationale or do not align with clear policy can result in reversal (for example, the repeal of section 25-90).

As noted above, the level of complexity will ensure that the anti-hybrid rules will prove difficult to administer in practice, for both taxpayers and the tax administrator. This risk is likely to be exacerbated to the extent that jurisdictions fail to coordinate multilaterally as the OECD intends.

As outlined in the OECD Final Report, PwC recommends that the effective date for the rules be set far enough in advance, once exposure draft legislation is released, to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements.

Clarification will be required in relation to the non-application of Part IVA to affected taxpayers who restructure existing hybrid arrangements to avoid application of the anti-hybrid rules, noting that one of the design principles of the anti-hybrid rules is deterrence.

Finally, while it is acknowledged that the UK announced (back in 2014) implementation of the OECD developed anti-hybrid rules with effect from 1 January 2017, the UK have had a form of anti-hybrid rules since 2005. They released exposure draft legislation in December 2015 thereby providing at least 12 months for impacted taxpayers to restructure existing arrangements, with the benefit of draft legislation, to avoid any adverse tax consequences arising. Consistent with the OECD's recommendation, the UK have afforded a substantial amount of time for taxpayers to restructure their arrangements prior to their effective date.

Finally, to date, we are not aware of any other country that has formally announced their intention to implement the full suite of OECD developed anti-hybrid rules. The OECD recommendations were written on the basis that every country will adopt the same rules, however, it does not appear that this will happen.

Regulatory capital (questions 35 and 36)

PwC recommends that any hybrid regulatory capital exemption provided should be made available to all regulated entities - for example, Australian financial institutions and the insurance sector. This is consistent with the approach in the UK exposure draft legislation.

Conclusion

Our key areas of concern are (i) the complexity of the rules and the increased compliance burden expected to result from having to understand foreign tax rules, (ii) the potential for double taxation arising from a lack of rule coordination, (iii) the potential for uncertainty where the rules are not

appropriately integrated with domestic law, and (iv) any resultant adverse impact on the attractiveness or competitiveness of Australia, particularly in the absence of broader tax reform.

We acknowledge the difficulty of the subject matter and commend the Board for their work to date. We also encourage continued stakeholder engagement to identify and address further issues associated with the implementation of the anti-hybrid rules.

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If you have any further questions regarding our submission, please do not hesitate to contact Peter Collins on (03) 8603 6347 or Robert Hines on (02) 8266 0281.

Yours sincerely

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