Australian Government

The Board of Taxation

IMPLEMENTATION OF THE OECD HYBRID MISMATCH RULES

A Report to the Treasurer

the board of taxation

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The Board of Taxation

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FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Treasurer following its review of the Australian implementation of the hybrid mismatch rules developed by the Organisation for Economic Cooperation and Development (OECD) under Action Item 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan.

The Board has made 17 recommendations.

The Board appointed Karen Payne to oversee the review. The Board also appointed a Working Group consisting of Chris Vanderkley, Grant Wardell-Johnson, Mark Ferrier and Michael Fenner. The Working Group was also assisted by officials from the Treasury and the Australian Taxation Office (ATO).

A Consultation Paper was issued in November 2015. The Board held discussions and targeted consultation meetings with a range of stakeholders, both before and after the release of the Consultation Paper. The Board received ten written submissions.

The *ex officio* members of the Board — the Secretary to the Treasury, John Fraser, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the observations and recommendation in this report for advice to Government.

The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

Michael Andrew AO
Chair, Board of Taxation

Karen Payne
Chair of the Board's Working Group
Member, Board of Taxation

Executive Summary

A summary of the Board's key recommendations made in this report regarding implementation of Australia's hybrid mismatch rules is set out as follows:

Recommendation 1 (adoption of Action Plan 2 Report recommendations):

The Board recommends that Australia should adopt the Action 2 Report recommendations (each an OECD recommendation), with some minor modifications as recommended throughout this report.

Recommendation 2 (date of commencement):

The Board recommends that the hybrid mismatch rules should commence in Australia for payments made on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent.

Recommendation 3 (grandfathering and transitional arrangements):

The Board recommends that pre-existing arrangements should, as a general rule, not be grandfathered. However, as the legislation is developed, there may be certain categories of arrangements that may be appropriate for grandfathering (such as third party arrangements where there is significant detriment to investors arising from application of the hybrid mismatch rules).

The Board also considers that, as a general rule, transitional rules will not be required provided that sufficient notice is given to taxpayers on the proposed commencement date of the hybrid mismatch rules.

Recommendation 4 (de minimis threshold and purpose test):

The Board recommends that the hybrid mismatch rules do not include a:

- de minimis test; or
- purpose test.

However, the Board notes as an observation that a de minimis threshold should be considered as an option for simplifying the application of the imported mismatch rule.

Recommendation 5 (timing differences):

The Board recommends that:

- OECD recommendation 1 should not apply to financial instruments with a term of three years or less, where the hybrid mismatch is merely one of timing; and

- for financial instruments with a term longer than three years, the OECD recommendation 1 primary rule should apply to delay the ability of the Australian borrower to claim a deduction until the income is recognised for tax in the counterparty jurisdiction. Also, where the defensive rule is triggered in the case of an Australian lender, an amount would be included in the assessable income of the Australian payee each year an accruals deduction is claimed in the counterparty jurisdiction (with such assessable income being credited against any actual receipt, or the actual receipt being treated as non-assessable in the year of receipt).

This is a departure from the suggested approach in the Action 2 Report.

Recommendation 6 (adoption of OECD recommendation 2.1 and 2.2):

The Board recommends:

- the adoption of the optional OECD recommendation 2.1; and

- that the optional OECD recommendation 2.2 not be implemented immediately, but that it be left open to implement in the future if integrity concerns are identified.

Recommendation 7 (identifying dual inclusion income):

The Board recommends that a simple dual inclusion income approach be taken to avoid unnecessary complexity and minimise compliance costs for taxpayers. Excess amounts disallowed should be able to be carried forward to set off against dual inclusion income in another period.

Recommendation 8 (imported mismatch rule):

The Board recommends that consideration be given to possible mechanisms to reduce uncertainty and the potential compliance burden in applying the imported mismatch rule, whilst still ensuring an appropriate level of integrity.

The Board also strongly recommends that careful consideration be given during the legislative design process to ensure the interpretation and compliance issues identified with section 974-80 are not replicated in the imported mismatch rule. The Board also recommends that the Commissioner provide contemporaneous administrative guidance to assist both taxpayers and the ATO in applying the rule.

Observation 1

As an observation, the Board notes that consideration should be given towards either a de minimis test or other safe harbour test for the imported mismatch rule to minimise compliance and uncertainty (even if on a transitional basis until sufficient countries implement their own hybrid mismatch rules).

Recommendation 9 (exceptions):

The Board recommends that further consideration be given during the legislative design process to specific exceptions from the hybrid mismatch rules including, but not limited to:

- the exceptions recommended in the Action 2 Report, consistent with the approach taken under recommendation 1.5 in respect to special investment vehicles, including for securitisation vehicles;
- financial traders — repurchase agreements and securities lending agreements; and
- managed investment trusts (widely held).

Recommendation 10 (thin capitalisation):

The Board recommends that further consideration should also be given to:

- whether, in circumstances where a debt deduction is denied by operation of the hybrid mismatch rules, the hybrid debt to which the deduction relates should be excluded from the adjusted average debt calculation in all cases; and
- whether any other consequential changes are required to be made to the thin capitalisation rules as a result of the operation of the hybrid mismatch rules.

Recommendation 11 (interest withholding tax):

The Board recommends that interest withholding tax should continue to apply to interest payments on hybrid debt financing, unless it falls within an existing interest withholding tax exemption.

Recommendation 12 (general anti-avoidance regime):

The Board recommends that administrative guidance be provided by the Commissioner on whether, and under what circumstances, the general anti-avoidance rule in Part IVA will be applied to restructures undertaken by taxpayers to avoid the application of the hybrid mismatch rules.

Recommendation 13 (definitions):

Recommendation 13.1 (Financial Instrument)

The Board recommends that to maximise international harmonisation, the OECD's definition of 'financial instrument' in the Action 2 Report should be used in Australia's hybrid mismatch rules.

However, the Board recommends that the definition be clarified to note that for the purposes of the hybrid mismatch rules, the scope of the definition should be limited to where the instrument is also a 'financial instrument' for the purposes of Australian accounting standards and accounting principles.

The Board recommends that leases be specifically carved out of the 'financial instrument' definition. Other carve outs may also be appropriate and should be considered during the legislative design process.

Recommendation 13.2 (Structured Arrangement)

The Board recommends that the concept of structured arrangement be clearly defined in its scope and be well supported by guidance material to ensure taxpayers are able to easily assess whether their arrangements would be caught by the hybrid mismatch rules.

Although the Board does not recommend a specific 'widely held' or 'marketable securities' carve out, the Board notes that care should be taken in the development of legislation and ATO administrative guidance to clarify that, in general, such arrangements should not be captured by the definition of structured arrangement.

Recommendation 14 (OECD recommendation 5):

The Board recommends that OECD recommendation 5 not be implemented immediately, but that it be left open to implement in the future if integrity concerns arise and after the merits have been given further analysis.

Recommendation 15 (hybrid regulatory capital):

Deductible/frankable regulatory capital issuances can advantage banks and insurers with sufficient offshore operations and franking credit balances.

The Board considers that an appropriate policy response is one that provides, to the greatest extent possible, a level playing field between all regulated entities, allows for Australian regulated entities to diversify their sources of funding and minimises complexity, compliance and disruption to markets.

The application of the hybrid mismatch rules to regulatory capital would partially assist in achieving a more level playing field between all regulated entities. However, it may be possible to neutralise the hybrid mismatch outcomes of such arrangements in a manner which better facilitates a level playing field and goes further in achieving the other aims of diversification and minimising complexity, compliance and disruption. This would require a holistic review of Australia's tax treatment of regulatory capital, encompassing potential changes to section 215-10 and the franking streaming rules.

The Board recommends that further time be granted to consider the appropriate policy response to this matter given:

- the complexities and interactions involved;
- the limited time period in which this review was able to be undertaken, and
- the need to undertake a holistic review to assess and ensure unintended consequences do not arise.

The Board proposes to work with Treasury, the ATO and stakeholders to identify a workable solution. This further work will be undertaken as a matter of priority so that any commencement may align with the commencement date of the hybrid mismatch rules.

The Board notes that there are some strong arguments in favour of grandfathering or including transitional arrangements for existing deductible/frankable AT1 issuances for any changes ultimately recommended under this further review, to minimise market disruption and the impact on third party investors. Accordingly, the Board recommends appropriate grandfathering or transitional arrangements also be considered as part of the further review. Any cut off date for grandfathering or transitional arrangements should be clearly defined to minimise any disruption for future AT1 issuances, including issuances that may be made during the further review period.

Recommendation 16 (legislative and administrative issues):

The Board recommends:

- the hybrid mismatch rules be drafted as a separate regime in Australia's tax law;
- a balance of principles-based drafting setting out the high-level policy underpinning the hybrid mismatch rules, coupled with more precise drafting for areas of the rules which require clear boundaries to provide certainty in their application;
- the hybrid mismatch rules apply in priority to all other parts of Australia's tax law; and

- the Commissioner provide detailed administrative guidance contemporaneously with the introduction of the hybrid mismatch legislation.

Recommendation 17 (post-implementation review):

Acknowledging that there is a possibility that Australia will be one of the first countries to implement the hybrid mismatch rules, the Board recommends that a post-implementation review of Australia's hybrid mismatch legislation be undertaken, preferably after a number of other jurisdictions have implemented hybrid mismatch rules and in light of any further recommendations made or best practice approaches suggested by OECD Working Party 11 in relation to the implementation of the Action 2 Report.

Chapter 1: Introduction

Background

1.1 On 12 May 2015, the Board was asked to consult on the implementation of hybrid mismatch rules as developed by the OECD under Action 2 — *Neutralising the Effects of Hybrid Mismatch Arrangements* of the BEPS Action Plan.

1.2 Hybrid mismatch arrangements can result in double non-taxation, including long-term tax deferral. Such arrangements can reduce the collective tax base of countries around the world even though it may be difficult to determine which individual country has lost tax revenue. The OECD has developed recommendations regarding the design of hybrid mismatch rules to be implemented as part of domestic legislation under Action 2 of the BEPS Action Plan.

1.3 The terms of reference for this review were given to the Board on 14 July 2015 and are attached at Appendix C. The Action 2 Final Report (the Action 2 Report) was released by the OECD on 5 October 2015. The Board was asked to report on the Australian implementation considerations arising from the recommendations included in the Action 2 Report. The Board was asked in particular to identify an implementation strategy that has regard to:

1. Delivering on the objectives of eliminating double non-taxation, including long term tax deferral;
2. Economic costs for Australia;
3. Compliance costs for taxpayers; and
4. Interactions between Australia's domestic legislation (for example, the debt-equity rules and regulated capital requirements for banks), international obligations (including tax treaties) and the new hybrid mismatch rules.

1.4 The Board's review focused, at a high level, on identifying the major implementation considerations involved and making a recommendation as to the appropriate timing for implementation of these rules.

REVIEW PROCESS

Consultation

1.5 The Board's consultation process has involved:

- preliminary consultations in Sydney and Melbourne with invited practitioners;
- release of a Consultation Paper in November 2015 to invite and facilitate submissions;
- information sessions in Sydney and Melbourne in November 2015 to provide further context and background; and
- targeted consultation meetings with a number of key stakeholders, following the release of the Consultation Paper.

Submissions

1.6 The Board received ten written submissions in response to the Consultation Paper.

1.7 Submissions noted that given the complexity of the measures and the short reporting timetable, insufficient time had been allowed for a comprehensive consideration by participants of how best to implement the hybrid mismatch rules into the Australian tax system. In addition, participants consider that consultation on the detail of the hybrid mismatch rules would not be possible without the opportunity to review the legislative design of the proposed arrangments. For these reasons most submissions commented only on the key high level implementation issues, but not necessarily the more detailed aspects of implementation. The Board acknowledges this and has limited its recommendations in this Report to the key implementation issues.

1.8 The Board recommends that taxpayers are given ample opportunity to consult with Treasury in the legislative design process and comment on draft legislation for any hybrid mismatch measures prior to finalisation.

Board's report

1.9 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the members of the Working Group, Treasury and the ATO. However, the Board's recommendations reflect its independent judgment.

1.10 All legislative references in this Report are a reference to either the *Income Tax Assessment Act 1936* or the *Income Tax Assessment Act 1997*, unless otherwise stated.

Overview

1.11 The principal objective of the Action 2 Report recommendations is to neutralise the effects of hybrid mismatches to discourage uncompetitive arrangements (that is, ensure unfair tax advantages do not accrue for multinational groups as compared with domestic groups). The Action 2 Report concludes that hybrid mismatch arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned, with an overall negative impact on competition, efficiency, transparency and fairness. The OECD and G20 considered this approach to be the only comprehensive and coherent way to tackle global tax avoidance and to discourage uncompetitive arbitrage.

1.12 Action 2 Report recommends that arrangements be neutralised as follows:

- Where there is a deduction/no inclusion outcome (D/NI) — deny the payer the deduction (primary response) or require the inclusion of the income (secondary response).[1]
- Where there is a double deduction (DD) outcome for a single expenditure — deny the deduction in the parent jurisdiction.[2]

1.13 Specific recommendations apply under OECD recommendation 2 to restrict dividend exemptions or foreign tax credit relief, and OECD recommendation 5 to specifically address reverse hybrid arrangements. Imported mismatch arrangements that circumvent the other hybrid mismatch rules are addressed in OECD recommendation 8.

The OECD process

1.14 Australia has played an integral role in leading the G20 agenda and contributing to the OECD's work on addressing BEPS.

1.15 The OECD in its Explanatory Statement on the 2015 Reports indicated that, in respect to hybrid mismatch arrangements, countries have agreed a general tax policy direction. This means that, while a minimum standard was not reached, countries are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future.

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1 Refer to OECD recommendation 1 — hybrid financial instruments rule, 3 — disregarded hybrid payments rule, 4 — reverse hybrid rule and 8 — imported mismatch rule.

2 Refer to OECD recommendations 6 — deductible hybrid payments rule and 7 — dual resident payer rule.

The Australian Context

1.16 The Australian Government is committed to eliminate, in partnership with the OECD and through the G20, the tax advantage arising from the use of hybrid instruments and hybrid entities whilst ensuring investment activity is not compromised and that Australia remains an economically competitive place to do business.

1.17 A number of other countries have announced unilateral implementation of local versions of financial instrument hybrid mismatch rules prior to the release of the Action 2 Report,[3] and are considering what amendments are needed to reflect the full suite of OECD recommendations. At the time of this Report, the United Kingdom (UK) was the only jurisdiction to formally announce its commitment to implement the Action 2 Report recommendations (with a start date applying to payments made on or after 1 January 2017).[4] Australia is monitoring the progress of the UK's implementation of the Action Plan 2, as well as the implementation by other countries in relation to these matters.

UK Hybrid Rules

1.18 The UK released draft hybrid mismatch legislation on 9 December 2015. The draft legislation was developed following responses to a consultation document released in December 2014 seeking comments on the implementation of the Action 2 Report. The UK's draft legislation closely follows the OECD hybrid mismatch recommendations but has been adapted to UK law through the selective use of existing UK concepts and definitions.

1.19 The UK has announced that its hybrid mismatch rules will commence for payments made on or after 1 January 2017.[5] The draft UK hybrid mismatch legislation does not include any grandfathering or transitional provisions.

1.20 The draft UK hybrid mismatch legislation:

- implements most of the Action 2 Report recommendations;
- applies the hybrid mismatch rules where is it "reasonable to suppose" a hybrid mismatch would arise;
- excludes financial traders dealing in stock lending and repo transactions; and

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3 Including Japan and a number of EU countries.

4 The UK has existing anti-arbitrage rules which it intends to replace with the OECD recommendations.

5 The UK has announced that the hybrid mismatch rules proposed for the Finance Bill 2016 will be extended to include hybrid mismatches involving permanent establishments.

- temporarily excludes regulatory capital securities in relation to banking and insurance from the definition of financial instruments, with a view to considering further options and with any inclusions to be enacted through regulations at a later date.

EUROPEAN COMMISSION ACTION ON HYBRIDS

1.21 The European Commission (EC) announced an Anti-Tax Avoidance Directive (Directive) in January 2016 that includes rules to prevent companies from exploiting hybrid mismatch arrangements. Under the Directive, in the event of a hybrid mismatch, the legal characterisation given to a hybrid instrument or entity by the member state where a payment originates should be followed in the counterparty member state jurisdiction.

1.22 The approach adopted by the EC to align the legal characterisation of debt/equity rules and opaque/transparent entities within EU member countries goes beyond, but is not wholly inconsistent with the objects of the OECD Action 2 Report. The OECD did not recommend harmonisation of the legal characterisation of instruments and entities across all jurisdictions given the difficulty and likely disruption to domestic laws.

1.23 As at the date of this report, the EU has not yet announced when, and how, it will apply the Action 2 Report recommendations, in particular to transactions with counterparties outside of the EU.

Chapter 2: Adoption of the Action 2 Report

Background

2.1 As part of its terms of reference, the Board was asked to identify an implementation strategy that has regard to the economic costs for Australia and the compliance costs for taxpayers.

2.2 The Board invited submissions to consider the advantages and disadvantages of implementing the hybrid mismatch rules and comments on the key implementation costs, obstacles and compliance costs for taxpayers, the ATO and Government.

2.3 In general, submissions supported the work being done by the OECD to neutralise hybrid mismatch activities, but cautioned against:

- Australia adopting hybrid mismatch rules without due consideration of the economic impacts; and
- adoption of the hybrid mismatch rules in advance of its key trading partners.

2.4 Stakeholders submitted that Australia's decision to implement the Action 2 Report should be considered in light of the risk to Australia's tax base and the compliance costs involved in administering the hybrid mismatch rules. In other words, the costs and benefits to Australia should be weighed before Australia decides to proceed with the implementation of the rules.

Erosion of Australia's tax base

2.5 The Action 2 Report notes that hybrid mismatch arrangements result in a substantial erosion of the taxable bases of the countries concerned.

2.6 Australia already has comprehensive rules to address a number of the BEPS measures.[6] However, Australia's domestic tax law does not generally take account of the tax treatment of financial instruments, arrangements or entities in another jurisdiction,[7] which can give rise to hybrid mismatches. As such, unlike some of the

6 These include Thin Capitalisation rules, Controlled Foreign Company (CFC) rules, Transfer Pricing, General Anti-Avoidance rules in Part IVA and the Multinational Anti-Avoidance Law extension of Part IVA.

7 However, the foreign hybrid rules in Division 830 does take into account the entity and investor tax treatment in other jurisdictions.

other BEPS Action Plans, the Australian tax law does not currently meet the OECD recommendations to address hybrid mismatches in Action 2.

Economic costs

2.7 The Action 2 Report notes that hybrid mismatch arrangements can have an overall negative impact on competition, efficiency, transparency and fairness. The Action 2 Report also suggests that these negative impacts are an economic cost for the globalised world but are difficult to measure given the challenges in obtaining comprehensive data on the effects of hybrid mismatch arrangements.

2.8 To the extent that tax settings produce unintended and distortive effects on cross-border trade and investment, the BEPS process is intended to ensure that unintended non-taxation does not occur and that cross border investment is not favoured over equivalent domestic investment.

2.9 Implementation of the Action 2 Report recommendations is expected to have an economic impact on those taxpayers currently engaged in hybrid mismatch arrangements.

1. Firstly, unwinding or restructuring of existing arrangements by taxpayers is expected to give rise to one-off costs (for example, break costs, advisor fees and foreign exchange differences).

2. Secondly, for affected taxpayers, funding costs for cross-border financing arrangements will increase once hybrid financing is replaced. As Australia is a capital importing country, adopting the hybrid mismatch rules may adversely impact the cost of capital for some Australian entities. This impact may be exacerbated relative to other countries that choose not to implement the Action 2 Report recommendations. Some stakeholders submitted that adopting the Action 2 Report may affect Australia's competitiveness to attract foreign investment and the costs of Australian companies expanding offshore.

2.10 While it was noted that the figures released by the Parliamentary Budget Office estimated the cost of hybrid arrangements at A$50 million per annum, some submissions were sceptical of the estimates, particularly when weighed against the potential economic and compliance costs.

2.11 PwC submitted that detailed modelling of primary and secondary impacts should be conducted in advance of any decision to implement the Action 2 Report recommendations. PwC suggest that the implementation of the hybrid mismatch rules could have a detrimental impact on the Australian economy by potentially impacting foreign investment decisions and encouraging Australian business to seek access to capital overseas by relocating their business offshore.

Compliance costs

2.12 Submissions noted that implementation of the Action 2 Report will impose compliance obligations as taxpayers will be required to obtain sufficient information to identify and assess the expected tax treatment of instruments or entities in the counterparty jurisdiction. The Action 2 Report has limited the scope of most of its recommendations to related persons,[8] members of a control group[9] and structured arrangements.[10] For related party and control group transactions, it is expected that in most cases parties to a cross border arrangement would be aware, or be able to obtain confirmation, of the counterparty tax treatment. However, for widely held structured arrangements, this cost could be significant (additional complexities also arise with custodian and nominee holdings). Apart from regulatory capital, submissions did not identify any particular types of arrangements expected to fall within this latter category. To the extent there are challenges with obtaining relevant information for taxpayers to be able to assess their Australian tax position, information requirements may need to be included in contractual terms or issuance documents.

2.13 The hybrid mismatch rules are expected to operate on a self-assessment basis and should not raise significant on-going administration costs for the ATO. However, it will be necessary for the ATO to develop additional expertise, networks and processes for determining the tax treatment of an instrument or entity in an offshore jurisdiction to enable it to review or audit positions taken.

Board's consideration

2.14 The Board recognises the importance of the economic and compliance costs in implementing the Action 2 Report recommendations.

2.15 The Board also notes that it has not prepared or reviewed an economic or financial model to cost the Australian implications arising from implementation of the Action 2 Report recommendations, nor has it undertaken a cost/benefit analysis.

2.16 However, the Board notes that:

1. Treasury's assessment is that there is not expected to be a significant detrimental impact on Australia's economy from adopting the hybrid mismatch rules; and

2. the OECD recommendations, to some extent, pre-suppose that it is not possible to identify or model the implications arising from the Action 2 Report recommendations.

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8 OECD recommendation 1.
9 OECD recommendation 3, 4, 6 and 8.
10 OECD recommendation 1, 3, 4, 6 and 8.

2.17 Accordingly, the Board recommends, in principle, implementing the recommendations as set out in the Action 2 Report (as modified by this report), but in a manner which fits within Australia's existing laws, and minimises ongoing compliance costs and legislative complexity. In this regard, the Board has recommended throughout this report some minor modifications and exclusions to the Action 2 Report to achieve these aims, without compromising on the key principles underlying the Action 2 Report.

2.18 There are some aspects of the Action 2 Report which the Board has noted for further consideration and consultation post-issuance of this report. In particular, the Board recommends that further work be undertaken in relation to the application of the hybrid mismatch rules to banking and insurance regulatory capital, having regard to interactions with existing imputation provisions.

2.19 The Board also recommends that it, along with the working group appointed by the Board, should be consulted during the legislative design process to provide additional context and continuity on detailed drafting and implementation issues.

2.20 Where possible, efforts should be made during the legislative design process to reduce economic and compliance costs by implementing hybrid mismatch rules that are clear and certain in scope and effect. The hybrid mismatch rules should only come into force once there has been sufficient time for taxpayers to assess the impact of the changes and restructure their operations where necessary.

Recommendation 1

The Board recommends that Australia should adopt the Action 2 Report recommendations (each an OECD recommendation), with some minor modifications as recommended throughout this report.

CHAPTER 3: IMPLEMENTATION CONSIDERATIONS

DATE OF COMMENCEMENT OF THE HYBRID MISMATCH RULES

Background

3.1 The Action 2 Report does not prescribe a date by which countries should implement its recommendations. The Board's Consultation Paper sought views from stakeholders on an appropriate commencement date for the hybrid mismatch rules in Australia.

3.2 The UK has announced that its proposed hybrid mismatch rules will apply to payments made on or after 1 January 2017. Draft legislation was available in the UK for just over 12 months ahead of this implementation date. At the time of writing this report, no other jurisdiction has formally announced its commitment along with a commencement date for implementation of hybrid mismatch rules.

3.3 A number of stakeholders suggested that, as far as possible, Australia should remain in step with other major OECD countries. Given the expected adverse impacts to the cost of capital for Australian operations, these submissions noted that there was no advantage to Australia being an 'early adopter' of the hybrid mismatch rules.

3.4 Stakeholders recommended that Australia should seek to harmonise adoption of hybrid mismatch rules with the majority of its key trading partners, so as not to negatively impact business investment decisions and Australia's competitiveness. It was further noted that multilateral coordination would make it easier for both taxpayers to apply and the ATO to administer the hybrid mismatch rules.

3.5 Stakeholders noted in submissions the importance of announcing the commencement date as early as possible and the need for sufficient lead time to review the draft legislation before the hybrid mismatch rules commence. This will provide sufficient time and detail for taxpayers to properly consider the implications on their existing arrangements.

3.6 Ernst & Young submitted that the start date should, at a minimum, be at least six months from the time legislation is passed by Parliament, and should be no earlier than 1 July 2017. KPMG considered that 1 January 2018 should be the earliest possible start date. Several submissions also noted that UK taxpayers will have around 12 months to consider the draft legislation and restructure their arrangements prior to commencement of the hybrid mismatch rules.

Board's consideration

3.7 The Board acknowledges the complexity of the hybrid mismatch rules as developed by the OECD. The Board supports a sufficient lead time prior to commencement of the rules to allow taxpayers to assess their current arrangements and unwind or restructure existing arrangements where necessary. Given the inherent complexity of the hybrid mismatch rules, taxpayers should also be given the opportunity to review draft and final legislation before the hybrid mismatch rules commence to allow for consultation and certainty in their application.

3.8 The Board acknowledges the concern raised in some submissions about Australia adopting these rules ahead of its major trading partners. In balancing this against the need for Australia to adopt these rules within a reasonable timeframe, the Board considers a 1 January 2018 start date is appropriate, provided legislation is enacted with a sufficient lead time for taxpayers to restructure their affairs and funding arrangements with certainty.

3.9 The Board contemplated a staggered start date for the various recommendations, or alternatively, an earlier start date for new arrangements. However, both these options were rejected on the basis that the complexity of the measures could result in taxpayers facing difficulties in determining the application and interaction of the rules to their particular facts and circumstances without legislation.

3.10 For these same reasons, the Board also recommends that the 1 January 2018 start date should be delayed where legislation is not enacted by 30 June 2017. Taxpayers should be given a minimum period of six months to restructure with final legislation in place (and ideally 12 months with draft legislation). For this reason, the Board recommends the start date be the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent. The Board would also encourage the release of draft legislation 12 months in advance of the proposed commencement date to allow time for further consultation on the detailed design of the rules.

Recommendation 2

The Board recommends that the hybrid mismatch rules should commence in Australia for payments made on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent.

GRANDFATHERING AND TRANSITIONAL ARRANGEMENTS

Background

3.11 The Action 2 Report discourages the use of grandfathering for pre-existing structures and instruments. In any event, grandfathering may not be effective where other countries do not grandfather pre-existing arrangements, as the operation of their defensive rules may nonetheless operate to eliminate any hybrid mismatch.

3.12 The Action 2 Report suggests that countries can minimise the need for transitional rules by providing taxpayers with sufficient notice of the proposed hybrid mismatch rules.

3.13 Some submissions from stakeholders raised concerns that taxpayers locked into long term arrangements may be disadvantaged.

3.14 AmCham and The Tax Institute supported grandfathering of all existing arrangements (The Tax Institute noted this would particularly be the case for arrangements with third parties). It was noted that this would avoid the risk of parties incurring significant break fees for early repayment of debt, potential foreign exchange implications and advisor costs for longer term arrangements.

3.15 Other submissions supported grandfathering for regulatory capital instruments if these are included in the scope of the hybrid mismatch rules.

3.16 The UK Government stated in its consultation paper that the announcement of the UK rules in 2014 provided a sufficient period for businesses to unwind their existing hybrids. Exposure draft legislation was released in December 2015, over a year before the announced commencement date, and this legislation is expected to be finalised in April 2016. The UK Government considered that given the lead time, there was no need for transitional or grandfathering rules.

Board's consideration

3.17 Notwithstanding the potential break costs (and other costs) that may arise, the Board considers that pre-existing arrangements should not, as a general rule, be grandfathered.

3.18 However, as the legislation is developed, there may be certain categories of arrangements that are identified as appropriate for grandfathering (such as third party arrangements where there is significant detriment to investors arising from application of the hybrid mismatch rules).

3.19 The Board's consideration of grandfathering of regulatory capital instruments is set out in recommendation 15.

3.20 The Board considers that an announcement by the Government as soon as possible on the proposed commencement date of the hybrid mismatch rules should provide taxpayers with sufficient notice of the Government's intention to adopt the proposed measures. For existing arrangements or entities that will need to restructure as a result of the hybrid mismatch rules, the recommended start date (which is 1 January 2018 at the earliest) should allow for sufficient time for most arrangements to be restructured provided legislation is enacted in time. On this basis, the Board considers that as a general rule, there is no need for separate transitional rules for application of the hybrid mismatch rules. However, during the legislative design process it may be identified that particular categories of arrangements require transitional rules.

Recommendation 3

The Board recommends that pre-existing arrangements should, as a general rule, not be grandfathered.

However, as the legislation is developed, there may be certain categories of arrangements that are identified as appropriate for grandfathering (such as third party arrangements where there is significant detriment to investors arising from application of the hybrid mismatch rules).

The Board also considers that, as a general rule, transitional rules will not be required provided that sufficient notice is given to taxpayers on the proposed commencement date of the hybrid mismatch rules.

DE MINIMIS THRESHOLD

Background

3.21 The Action 2 Report does not propose a general de minimis or materiality threshold given the scope restrictions provided for in certain recommendations.

3.22 There are a number of materiality or de minimis thresholds that apply in other aspects of Australian tax law. De minimis thresholds are typically used as a means of ensuring that tax measures are targeted at particular taxpayers to minimise compliance costs.

3.23 AmCham and PwC submitted that a de minimis rule currently exists in other areas of international tax integrity laws and should be considered in the hybrid mismatch rules to minimise compliance costs on taxpayers.

Board's consideration

3.24 The Board considers that, unless there is a compelling reason to do otherwise, the implementation of hybrid mismatch rules in Australia should align with the Action 2 Report recommendations to ensure coordination, comprehensiveness and consistency with other jurisdictions. Hybrid mismatch rules that are narrower in their scope and application in one jurisdiction are likely to result in the counterparty jurisdiction applying their hybrid mismatch rules to neutralise the mismatch, thereby benefitting the other jurisdiction.

3.25 Typically, hybrid issuances will be of sufficient quantum to make the additional costs of compliance worthwhile. Unless the de minimis threshold was set at quite a high level, which in the Board's view is not appropriate, it is expected that in practice most hybrid financing arrangements would fall above the threshold. It would predominately be investors in widely held financing arrangements that would likely fall within the de miminis.

3.26 In the Board's view, the operation of the defensive rules (where counterparty jurisdictions do not adopt a de minimis) and the likely narrow application of a threshold would mean that limited compliance benefits would be achieved from a broad based de minimis exemption. Further, such a de minimis threshold may come at a potential cost to Australia's revenue as a result of operation of the defensive rules. On this basis, the Board does not recommend a de minimis rule be included for application of Australia's hybrid mismatch rules.

3.27 However, the Board notes as an observation that a de minimis threshold should be considered as an option for simplifying the application of the imported mismatch rule. This is discussed further at paragraph 3.73.

PURPOSE TEST

Background

3.28 The hybrid mismatch rules have been designed to apply automatically without regard to purpose. Given the multilateral approach taken in the Action 2 Report, a purpose test was deemed unnecessary given that the rules are designed to neutralise a mismatch regardless of where the tax benefit arises.

3.29 General anti-avoidance tax laws have generally relied on some form of purpose test that requires a tax administration to show a link between an arrangement and the avoidance of that particular jurisdiction's tax. In Australia, the general anti-avoidance rule in Part IVA largely relies on a 'sole or dominant purpose test' and the recent multinational tax anti-avoidance law (MAAL) in section 177DA relies on a principal purpose test.

Board's consideration

3.30 The Action 2 Report intended that the hybrid mismatch rules apply to neutralise a mismatch regardless of their purpose.

3.31 Each jurisdiction has its own interpretation and application of a purpose test and it would be difficult to harmonise in practice how a purpose test would work and be consistently applied across different jurisdictions.

3.32 An automatic approach that avoids the need to establish the purpose of a hybrid arrangement or hybrid entity ensures that taxpayers and tax administrations do not have to distinguish between acceptable and unacceptable mismatches.

3.33 For these reasons, the Board considers the hybrid mismatch rules should apply to taxpayers and arrangements automatically without the need to assess purpose. The Board supports rules that are mechanical in operation to minimise compliance and administration costs for both taxpayers and tax administrations by providing certainty in their application.

Recommendation 4

The Board recommends that the Australian hybrid mismatch rules do not include a:

- de minimis test; or
- purpose test.

However, the Board notes as an observation that a de minimis threshold should be considered as an option for simplifying the application of the imported mismatch rule.

TIMING DIFFERENCES

3.34 The Action 2 Report notes that OECD Recommendation 1 does not generally apply to differences in the timing of the recognition of payments under a financial instrument, provided that the payment is included in income within a reasonable period of time. Whilst 'a reasonable period of time' is not defined, the OECD has recommended a safe harbour of 12 months. However, it remains open to countries to determine an alternate reasonable period of time (having regard to indicators suggesting arm's length dealings). The OECD recommends that deferrals of income recognition beyond a reasonable period of time be dealt with by way of a permanent denial of a deduction in the counterparty jurisdiction (as the primary rule).

3.35 The UK has adopted a 12 month safe harbour in line with the Action 2 Report but provides flexibility for a longer period if taxpayers can provide HM Revenue & Customs (HMRC) with evidence to justify that the timing difference is reasonable.

3.36 Submissions did not comment specifically on this matter, but PwC did note that the hybrid mismatch rules should not be at the cost of double taxation as this would be detrimental to global commerce.

Board's consideration

3.37 The Board considers that a 12 month safe harbour period would be too short. Financing instruments would typically have terms that extend beyond a 12 month period. Timing differences beyond a 12 month period are likely to arise simply where jurisdictions use different accounting or tax periods and/or different rules for recognising when items of income or expenditure have been derived or incurred.

3.38 The Board also had significant concerns with the requirement that arrangements beyond a 'reasonable' period of time could give rise to a permanent denial of the deduction to the payer. In addition, under the defensive rule the forced inclusion of income for the Australian lender at the same time as a deduction is claimed by the counterparty, could give rise to double taxation outcomes where the lender is also required to include the actual payment in its assessable income at the time of receipt. In the Board's view, such a response is disproportionate to the timing mismatch it is seeking to address and can lead to economic double taxation outcomes for commercially driven financing structures.

3.39 Financing arrangements entered into for genuine commercial reasons could potentially be denied a permanent deduction merely from the operation of Australia's Taxation of Financial Arrangement (TOFA) rules requiring recognition of an accruals deduction where the counterparty jurisdiction recognises the income on a cash received/paid basis.

3.40 Whilst the Action 2 Report contemplates an extension beyond the 12 month safe harbour (that is, where the tax administration considers this reasonable in the circumstances), in the Board's view this would result in an administrative burden on the ATO to provide guidance and it would create significant uncertainty for taxpayers. A requirement to obtain tax administration clearance for instruments that have a timing difference of greater than 12 months, as proposed under the UK draft legislation, would also increase compliance costs for taxpayers and could cause delays in financing commercial transactions. In coming to its view, the Board has weighed up these additional compliance costs against the need for the elimination of a timing deferral (where the only loss to revenue is the time value of money for the period).

3.41 The Board considers that a three year safe harbour period strikes the right balance between ensuring long term deferral arrangements are no longer possible, and reducing compliance costs and uncertainty for taxpayers. It would also relieve the administrative burden on the ATO. The Board also considers that a permanent denial of a deduction should not arise for timing differences beyond the three year safe harbour period. Instead, the deduction or relevant part of the deduction should be delayed until such time that the equivalent amount of income is recognised for tax purposes in the counterparty jurisdiction. Also, where the defensive rule is triggered in the case of an Australian lender, an amount would be included in the assessable income of the Australian payee each year an accruals deduction is claimed in the counterparty jurisdiction (with such assessable income being credited against any actual receipt, or the actual receipt being treated as non-assessable in the year of receipt).

3.42 The Board acknowledges that if countries adopt different safe harbour time periods to deal with timing differences, this could make it difficult for taxpayers operating cross border to determine which country will look to neutralise the mismatch. However, these difficulties would arise in any event with individual countries determining 'a reasonable period of time' for deferral on a country by country basis, and on a case by case basis.

3.43 Further consideration should be given in the legislative design to whether transitional arrangements are required for existing deferral arrangements (for example, whether existing arrangements with less than 3 years to run should be subject to recommendation 1).

Recommendation 5

The Board recommends that:

- OECD recommendation 1 should not apply to financial instruments with a term of three years or less, where the hybrid mismatch is merely one of timing; and
- for financial instruments with a term longer than three years, the OECD recommendation 1 primary rule should apply to delay the ability for the Australian borrower to claim a deduction until the income is recognised for tax in the counterparty jurisdiction. Also, where the defensive rule is triggered in the case of an Australian lender, an amount would be included in the assessable income of the Australian payee each year an accruals deduction is claimed in the counterparty jurisdiction (with such assessable income being credited against any actual receipt, or the actual receipt being treated as non-assessable in the year of receipt).

This is a departure from the Action 2 Report suggested approach.

ADOPTION OF OECD RECOMMENDATION 2.1

Background

3.44 Recommendation 2 applies to a dividend exemption or equivalent tax relief.[11] There is otherwise no limitation on the scope of this recommendation as it can apply to any arrangement and not just structured arrangements or arrangements entered into between related parties. The recommendation is split into two parts:

- OECD recommendation 2.1 applies to deny the payee a dividend exemption or equivalent tax relief to the extent the payment is deductible to the payer; and
- OECD recommendation 2.2 sets out a rule to restrict foreign tax credits under a hybrid transfer.

3.45 Where OECD recommendation 2.1 is adopted by the payee jurisdiction (such that the payee is denied a dividend exemption), it should not be necessary for the payer jurisdiction to then apply OECD recommendation 1 to deny a deduction, as any hybrid mismatch will have already been eliminated.

3.46 Various submissions submitted that franking credits should not be classified as 'equivalent tax relief',[12] on the basis that an imputation credit is only available for distribution where previously undistributed profits of the payer have borne company tax in Australia.

3.47 Recommendation 2.2 sets out a rule to restrict foreign tax credits under a hybrid transfer, to align the availability of withholding tax relief with the economic benefit of the payment. This could arise under a securities lending arrangement where both the borrower and lender are treated as deriving the dividend income under their respective jurisdictions and both parties seek to claim withholding tax relief. The rule would operate to restrict the amount of credit in proportion to the net taxable income of the payer under the arrangement.

3.48 The OECD recommendation 2 is optional for countries to adopt. In the Australian context, adoption of recommendation 2.1 may require a change to Australia's existing dividend exemption in Subdivision 768-A. It is expected that most countries that provide a dividend exemption or equivalent tax relief will adopt OECD recommendation 2.1.

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11 Equivalent tax relief may include domestic tax credits, foreign tax credits or dividends taxed at a reduced rate.

12 Commonwealth Bank of Australia, Macquarie Group Limited, National Australia Bank Limited, Westpac Banking Corporation and the Insurance Australia Group.

Board's consideration

OECD recommendation 2.1

3.49 The Board supports the adoption of OECD recommendation 2.1. Further work should be undertaken during the legislative design process or through administrative guidance to clarify the scope of OECD recommendation 2.1 in an Australian context.

OECD recommendation 2.2

3.50 At present, there has been no empirical evidence presented to the Board that suggests there is an integrity risk to the Australian taxation base if OECD recommendation 2.2 were not implemented. The Board does not support implementation of OECD recommendation 2.2 where there is no significant integrity concern identified.

3.51 That said, the Board is of the view that, if a significant integrity concern arises in the future, implementation of OECD recommendation 2.2 should be reconsidered. In doing so, the integrity risks should be weighed against the compliance and complexity in determining an appropriate response.

Recommendation 6

The Board recommends:

- the adoption of the optional OECD recommendation 2.1; and
- that the optional OECD recommendation 2.2 not be implemented immediately, but that it be left open to implement in the future if integrity concerns are identified.

IDENTIFYING DUAL INCLUSION INCOME

Background

3.52 The Action 2 Report has recommended that tax administrations should consider simple implementation solutions to tracking items of dual inclusion income to avoid complexity and minimise compliance costs. Tracking and identifying items of dual inclusion income is relevant in determining whether a deduction should be restricted under OECD recommendations 3, 6 and 7.

3.53 These OECD recommendations apply in the following circumstances:

- permanent mismatches that arise from the different tax treatment of payments in two different jurisdictions; and
- timing differences between jurisdictions or over different year-ends (however there are specific rules to address timing rules, as discussed below).

3.54 An item of income should be treated as dual inclusion income if it is taken into account as income under the laws of both the payer and payee jurisdictions regardless of whether that income is subject to double taxation relief by way of an exemption or credit. Timing and valuation differences in the recognition of income should not be regarded as giving rise to a mismatch.

3.55 To address timing differences, OECD recommendations 3, 6 and 7 suggest that jurisdictions allow carry-forward or carry-back of double deductions to other taxable periods where they can be set-off against surplus dual inclusion income. It contemplates that domestic provisions that deal with loss utilisation would apply.

3.56 Income that is attributed under a CFC regime may be treated as dual inclusion income if the taxpayer can satisfy to the tax administration that the effect of the CFC regime is to bring the income into tax at the full rate under the laws of both jurisdictions.

3.57 Submissions contained limited comments on this issue. AmCham noted difficulties that can arise in determining dual inclusion income between United States (US) and Australian tax laws, particularly in respect of reversals where the income is recognised at a later point in time. The treatment of future dividend income as assessable in the US may depend on a variety of factors. Differences can arise in the calculation of taxable income for Australian tax purposes compared to the US. AmCham provided an example where, under the US tax law, an amortisation deduction for goodwill is generally provided over fifteen years, whereas no such deduction is available under the Australian tax law. It was also noted that the US may be able to shelter tax payable using foreign tax credits from other jurisdictions.

Board's consideration

3.58 The Board acknowledges the practical difficulties that can arise in determining dual inclusion income where income is recognised at a later point in time. Consideration should be given during the legislative design process to approaches aimed at minimising compliance difficulties.

3.59 The Board's recommendation is set out below.

Recommendation 7

The Board recommends that a simple dual inclusion income approach be taken to avoid unnecessary complexity and minimise compliance costs for taxpayers. Excess amounts disallowed should be able to be carried forward to set off against dual inclusion income in another period.

IMPORTED MISMATCH RULE

Background

3.60 The imported mismatch rule in OECD recommendation 8 is designed to prevent taxpayers from entering into structured arrangements or arrangements with group members in jurisdictions that have not introduced hybrid mismatch rules, to indirectly shift the tax advantage from the hybrid mismatch to a jurisdiction that has not applied the rules. This may be through the use of non-hybrid instruments such as an ordinary loan to an Australian entity, which has been ultimately funded through a hybrid mismatch arrangement elsewhere in the group.

3.61 The imported mismatch rule is designed to disallow deductions for a broad range of 'payments' including interest, royalties, rents and payments for services (excluding amounts treated as consideration for the disposal of an asset). The intention of the rule is to capture any transfer of value from one entity to another.

3.62 The Action 2 Report considers the imported mismatch rule necessary to maintain the integrity of the other hybrid mismatch rules and notes that while the imported mismatch rule involves an unavoidable degree of coordination and complexity, it only applies to the extent a multinational group generates an intra-group hybrid deduction.

3.63 Tracing and priority rules will need to apply to determine the extent to which a payment should be treated as a set-off against a deduction under an imported mismatch arrangement.[13]

3.64 Concerns have been raised in consultations and submissions that the potential operation of this rule could give rise to considerable complexity and compliance. It is noted that there are other provisions in the existing tax law, such as section 974-80,[14] that require tracing of funding arrangements between chains of entities. Equally, there have been practical difficulties associated with tracing and apportionment, which is illustrated by a significant body of Australian case law.[15]

3.65 PwC's submission notes that section 974-80 has been the subject of considerable commentary, debate and consultation between the ATO, Treasury and the private sector for the best part of a decade, which culminated in the Government's announcement in April 2015 to repeal the provision and replace it with a new

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13 Paragraph 246 of the Action 2 final Report sets out the suggested priority rules ((1) structured imported mismatches, (2) direct imported mismatches, and (3) indirect imported mismatches).

14 The Government announced in April 2015 that, as recommended by the Board in its report following its review of the debt and equity tax rules, section 974-80 will be repealed and replaced with a new aggregation principle.

15 For example, some cases that have dealt with tracing include, but are not limited to, *Fletcher & Ors v Federal Commissioner of Taxation [1990] 90 ATC; Re Kidston Goldmines Limited v Commissioner of Taxation [1991] FCA 277; and Ronpibon Tin NL & Tongka compound NL v Federal Commissioner of Taxation [1949] HCA 15.*

aggregation provision that provides clearer boundaries in its application. This was at the recommendation of the Board following its post-implementation review of the debt and equity tax rules in 2014-2015.[16]

Board's consideration

3.66 In the Board's view, the imported mismatch rule could present considerable compliance challenges for taxpayers and will be difficult for the ATO to administer effectively. This is particularly due to the inherent design features embedded within the imported mismatch rule and the requirement to trace funding flows through (potentially multiple and unlimited) chains of related entities and jurisdictions.

3.67 One of the difficulties associated with the imported mismatch rule is that taxpayers will need to understand the tax treatment of payments in the hands of parties other than those with whom they are directly transacting. That is, taxpayers will need to understand the foreign tax treatment of payments that may have no direct connection with their particular operations, and will need to keep abreast of any legislative developments in those foreign jurisdictions that may change the position taken in Australia. This assumes there is an appropriate level of transparency within the group. Additionally, taxpayers will need to understand implications of foreign currency and valuation differences.

3.68 Having regard to these factors, the imported mismatch rule is expected to cause a significant burden to taxpayers in having to disprove the existence of any imported mismatch anywhere in the chain of intercompany transactions. Similar to the issues that arose from section 974-80, practical difficulties can arise where there is no clear chain of financial arrangements, and hybrid financing is mixed with funds from other sources before provision to the Australian borrower.

3.69 The complexity is further compounded as the imported mismatch rules apply more broadly than just financial arrangements, with application extending to other types of payments. This could impact intra-group supply chains and non-financing transactions where there is a hybrid financing arrangement somewhere in the global group that may be viewed under the relevant tax law as part of an imported mismatch scenario.

3.70 From an administrative perspective, the ATO (and revenue authorities globally) 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 not impacted or caused consequences from an Australian revenue perspective.[17]

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16 The Board of Taxation, Review of the debt and equity tax rules (2015). Retrieved from: http://taxboard.gov.au/files/2015/07/Debt_Equity_Final_Report.pdf.

17 See PwC submission.

3.71 Once most countries in the OECD have adopted hybrid mismatch rules, it is expected that the imported mismatch rule will seldom be activated. However, by Australia adopting the hybrid mismatch rules in advance of most countries, this may place an unfair compliance burden on Australian entities. Care will need to be taken to ensure double taxation outcomes do not inadvertently arise as other countries start to implement their own hybrid mismatch rules.

3.72 Given the above issues, the Board recommends that consideration be given to mechanisms to reduce uncertainty and the potential compliance burden, whilst still ensuring an appropriate level of integrity.

3.73 By way of observation, the Board notes that consideration should be given to the introduction of either a de minimis threshold test (for example, similar to the recently enacted 'significant global entity' threshold in the MAAL) or some other form of safe harbour test to help mitigate the cost of compliance and administration, and to minimise uncertainty. This could even apply on a transitional basis until a sufficient number of countries implement their own hybrid mismatch rules.

3.74 In any event, the Board strongly recommends that careful consideration should be given to the legislative drafting process to ensure that the interpretation and compliance issues identified with section 974-80 are not replicated in the imported mismatch rule. The Board also recommends that detailed administrative guidance be provided by the Commissioner to assist both taxpayers and the ATO in applying this rule (particularly around the tracing of funding and apportionment of deductions).

Recommendation 8

The Board recommends that consideration be given to possible mechanisms to reduce uncertainty and the potential compliance burden in applying the imported mismatch rule, whilst still ensuring an appropriate level of integrity.

The Board also strongly recommends that careful consideration be given during the legislative design process to ensure the interpretation and compliance issues identified with section 974-80 are not replicated in the imported mismatch rule. The Board also recommends that the Commissioner provide contemporaneous administrative guidance to assist both taxpayers and the ATO in applying the rule.

Observation 1

As an observation, the Board notes that consideration should be given towards either a de minimis test or other safe harbour test for the imported mismatch rule to minimise compliance and uncertainty (even if on a transitional basis until sufficient countries implement their own hybrid mismatch rules).

OTHER EXCEPTIONS

Background

3.75 The Action 2 Report considered that securitisation vehicles and certain investment vehicles[18] should be carved out from the hybrid financial instrument rule to protect the tax neutrality of these vehicles.[19]

3.76 The UK in its draft hybrid mismatch legislation has proposed to exclude:

- financial traders dealing in stock lending and repo transactions; and
- widely held vehicles such as offshore funds or authorised investment funds including unit trusts and open-ended investment companies.

Board's consideration

3.77 The Board's recommendation is set out below.

Recommendation 9

The Board recommends that further consideration be given during the legislative design process to specific exceptions from the hybrid mismatch rules including, but not limited to:

- the exceptions recommended in the Action 2 Report, consistent with the approach taken under recommendation 1.5 in respect to special investment vehicles, including for securitisation vehicles;
- financial traders — repurchase agreements and securities lending agreements; and
- managed investment trusts (widely held).

18 The OECD paper refers to investment vehicles in a jurisdiction that grants the vehicle the right to deduct dividend payments.

19 OECD recommendation 1.5.

CHAPTER 4: INTERACTION WITH AUSTRALIA'S TAX LAWS

INTRODUCTION

4.1 There are a number of operational and integrity measures in Australia's domestic tax law that already apply to financial instruments, such as the debt/equity rules, TOFA, thin capitalisation, withholding tax and transfer pricing. Furthermore, Australia has comprehensive integrity rules, including Part IVA, thin capitalisation, controlled foreign company (CFC) rules and the newly enacted MAAL.

4.2 It is fully expected that implementation of the hybrid mismatch rules will cause interaction issues with domestic tax law given the overlap in application. Throughout the consultation process, and highlighted in a number of submissions, stakeholders cited the difficulty in identifying all potential interactions both in the limited time available, and without draft legislation.

4.3 With the assistance of submissions received, the Board has sought to identify some interaction issues that are likely to arise upon implementation of the hybrid mismatch rules into the Australian domestic tax law.[20] However, the Board recommends that the legislative design process provides sufficient opportunity to consult further with stakeholders on interaction issues following this review to ensure that outcomes accord with existing policy objectives.

THIN CAPITALISATION

4.4 The Australian thin capitalisation rules in Division 820 are an integrity rule designed to limit allowable debt deductions[21] taken by taxpayers on cross-border investments by applying a statutory ratio or formula.

4.5 Stakeholders raised concerns regarding interaction of the hybrid mismatch rules and the thin capitalisation rules. Submissions made to the Board[22] stated that where a debt deduction is denied by operation of the hybrid mismatch rules, the debt to which the deduction relates should not continue to be included in the adjusted average debt calculation.

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20 Another example not listed below is whether foreign exchange differences should be treated as non-assessable non-exempt income where deductibility of payments have been denied under the hybrid mismatch rules.

21 A debt deduction is defined to include interest and amounts in the nature of interest.

22 See CTA, EY and PwC submissions.

Board's consideration

4.6 The Board agrees with the views in submissions that taxpayers should not be penalised more than once as a result of the hybrid mismatch rules. If hybrid financing arrangements for which a debt deduction has been denied for the whole year by operation of the hybrid mismatch rules are included as adjusted average debt in the thin capitalisation calculation, taxpayers in some instances could have debt deductions denied that have no connection with hybrid financing. This would further increase the cost of capital for multinational companies.

4.7 However, not including hybrid debt as adjusted average debt but including the Australian asset funded by the hybrid debt in the safe harbour amount may give rise to a greater safe harbour amount than could otherwise be achieved. Further, the appropriate thin capitalisation interaction policy response may differ for arrangements denied a deduction under a DD hybrid arrangement compared to a D/NI hybrid arrangement.

4.8 Accordingly, the Board considers it appropriate to give further consideration to the treatment of hybrid debt for thin capitalisation purposes (including whether a rule similar to that of cost-free debt capital is required and whether it should be included as a non-debt liability or simply excluded from the thin capitalisation calculation altogether).

Recommendation 10

The Board recommends that further consideration should also be given to:

- whether, in circumstances where a debt deduction is denied by operation of the hybrid mismatch rules, the hybrid debt to which the deduction relates should be excluded from the adjusted average debt calculation in all cases; and
- whether any other consequential changes are required to be made to the thin capitalisation rules as a result of the operation of the hybrid mismatch rules.

INTEREST WITHHOLDING TAX

4.9 The Action 2 Report left it open for countries to determine whether interest withholding tax should continue to apply to interest payments made to non-residents that are denied a deduction under the hybrid mismatch rules.

4.10 A number of submissions made to the Board took the view that interest withholding tax should not be imposed on non-deductible hybrid debt arrangements. It was considered that if interest withholding tax were still applied, a more onerous outcome would be produced than paying dividends on common equity. Notwithstanding withholding tax is a tax liability of the non-resident payee, this could impact the cost of capital in Australia as a result of the operation of potential 'gross up' clauses that operate where withholding tax is imposed.

Board's consideration

4.11 The Board acknowledges the possible flow on effect of outcomes arising from the operation of the hybrid mismatch rules and the imposition of interest withholding tax on cross-border payments. The Board also understands that interest withholding tax collected on a deduction that is denied as a result of the hybrid mismatch rules will be considered commercially inefficient by Australian borrowers. However the Board notes that the withholding tax relates to income that is otherwise not included or taxed in the foreign jurisdiction (and presumably therefore not subject to transfer pricing considerations). On balance, the Board is of the view that interest withholding tax should continue to apply to interest payments from hybrid debt financing, unless it falls within an existing interest withholding tax exemption, even where a primary or secondary rule is applied to the payment.

4.12 If an exemption from interest withholding tax were applied to hybrid debt financing, then such arrangements could be an effective tax planning tool. Withholding tax obligations could be circumvented by issuing hybrid debt financing in place of equity financing (potentially saving the use of franking credits).

4.13 The Board does not consider it appropriate to instead apply dividend withholding tax rates or exemption to, or allow franking of, hybrid finance interest payments, on the basis that the hybrid mismatch rules do not operate to re-characterise the instrument from debt to equity for Australian tax purposes.

4.14 It is acknowledged that some taxpayer groups with hybrid financing will be worse off than if had they used equity financing. However, the hybrid mismatch rules are intended to have behavioural effects, encouraging taxpayers to replace hybrid financing with non-hybrid financing. The imposition of interest withholding tax on hybrid debt financing arrangements will further encourage this, albeit some existing arrangements may not be in a position to restructure.

Recommendation 11

The Board recommends that interest withholding tax should continue to apply to interest payments on hybrid debt financing, unless it falls within an existing interest withholding tax exemption.

General anti-avoidance regime (Part IVA)

4.15 The Australian tax law contains an overarching general anti-avoidance provision, otherwise known as Part IVA. Part IVA is designed to apply to schemes entered into with the sole or dominant purpose of obtaining a tax benefit.

4.16 Throughout the consultation process, a number of stakeholders raised concerns about whether the Commissioner would seek to apply Part IVA in circumstances where a taxpayer restructures existing hybrid arrangements in response to the hybrid mismatch rules to be introduced — that is, to avoid the potential application of the hybrid mismatch rules. Examples cited included replacement of a mandatory redeemable preference share (MRPS) issued by an Australian resident company to a non-resident parent company with an interest bearing loan, which preserves the Australian tax deduction but eliminates any D/NI outcome. Another example was replacement of MRPS with an interest bearing loan with another subsidiary in the same corporate group located in a low or no-tax jurisdiction.

4.17 Submissions made to the Board supported restrictions being placed on the application of Part IVA in these circumstances; particularly given one of the explicit design principles of the hybrid mismatch rules is deterrence, for example, encouraging a restructure to remove hybrid financing.

Board's consideration

4.18 The Board recognises that the clear intent of the hybrid mismatch rules is to deter taxpayers from using hybrid arrangements to exploit differences in country's tax regimes.

4.19 In response to implementation of hybrid mismatch rules into Australia's domestic tax law, the Board expects many affected taxpayers will restructure their existing arrangements in an effort to preserve deductions in the payee jurisdiction for financing costs.

4.20 It is beyond the scope of this report for the Board to comment on the appropriateness of replacement structures. For example, transactions with low or no tax jurisdictions; or transactions where returns are exempt from taxation in the payee jurisdiction on the basis that that jurisdiction operates on a territorial basis of taxation, which may still achieve a D/NI outcome but are explicitly outside the operation of the Action 2 Report recommendations. Whether or not it is appropriate for Part IVA to apply will depend on the specific facts and circumstances in each case.

4.21 Accordingly, the Board does not recommend a legislative carve out or amnesty period from the operation of Part IVA for restructures that take place in anticipation of the hybrid mismatch rules. The Commissioner should retain the right to challenge arrangements restructured in an artificial or contrived manner.

4.22 However, the Board notes the views of Justice Hill in *CPH Property Pty Ltd v. Federal Commissioner of Taxation* (1998) 88 FCR 21 that:

> … the time for testing the dominant purpose must be the time at which the scheme was entered into or carried out and by reference to the law as it then stood.

4.23 Accordingly, even absent a legislative carve out, restructures undertaken for the purpose of exiting hybrid mismatch arrangements prior to the commencement of the hybrid mismatch rules should not in itself attract the operation of Part IVA. However, artificial or contrived replacement structures could still potentially be subject to Part IVA (although the counterfactual should not have regard to the operation of the hybrid mismatch rules).

4.24 To provide greater certainty to taxpayers seeking to restructure, the Board recommends detailed administrative guidance (with illustrative examples) be provided by the Commissioner, in consultation with the taxpaying community, on whether, and under what circumstances, Part IVA will be applied to restructures undertaken to avoid the application of the hybrid mismatch rules and preserve an existing position, having regard to Justice Hill's comments above. The Board recommends that the administrative guidance be provided contemporaneously with the introduction of hybrid mismatch legislation to allow taxpayers to structure their affairs with certainty (and for draft administrative guidance to be made available at the same time as the draft legislation).

Recommendation 12

The Board recommends that administrative guidance be provided by the Commissioner on whether, and under what circumstances, the general anti-avoidance rule in Part IVA will be applied to restructures undertaken by taxpayers to avoid the application of the hybrid mismatch rules.

DEFINITIONS

4.25 Chapters 10, 11 and 12 of the Action 2 Report include a number of definitions. Specific comment is made below on the definition of 'financial instrument' and 'structured arrangement'.

Board's consideration

4.26 The Board considers that broadly speaking, to ensure international consistency Australia should use the definitions set out in the Action 2 Report for the purposes of implementing the hybrid mismatch rules. However, there may be certain definitions where it is more appropriate for Australia to utilise existing definitions in its tax law to reduce compliance costs and uncertainty for taxpayers. Such an approach should be appropriate unless the defined term does not align in principle with the definition included in the Action 2 Report.

4.27 The detail of the definitions and the interactions with existing definitions should be more closely considered as part of the legislative design process.

Financial Instrument

4.28 OECD recommendations 1 and 2 apply to hybrid 'financial instruments'. OECD recommendation 1 includes a definition of financial instrument, as 'any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and the payer jurisdiction and includes a hybrid transfer.'

4.29 The UK draft hybrid mismatch rules have taken the approach of using domestic definitions to the extent possible. Their definition of 'financial instrument' in their hybrid mismatch draft legislation captures arrangements which fall within their domestic rules for loan relationships, derivative contracts and factoring arrangements. It also extends to share capital and anything else that is a financial instrument within UK generally accepted accounting practice.

4.30 Australia's tax laws include a number of different definitions for financial arrangements. The definition of 'financial arrangement' in the TOFA regime in Division 230 generally applies to debt, equity and derivative instruments.[23] Under this definition, most instruments that are 'financial arrangements' for Division 230 purposes will also meet the definition of 'financial instrument' in the accounting standard AASB 132. There is a Treasury review project underway for TOFA which is expected to provide even greater alignment to the accounting definition, which should be monitored during the legislative design process of the hybrid mismatch rule.

4.31 The debt and equity tax rules in Division 974 also contain a definition of 'financing arrangement'. Broadly, under this definition, a scheme will be a financing arrangement where it is undertaken or entered into to raise finance for the entity.[24]

4.32 Submissions made to the Board generally did not comment on the appropriate definition of 'financial instrument' in Australia's hybrid mismatch rules. That said, some submissions did make a general observation that existing Australian tax law definitions should be used where possible as opposed to implementing 'new' OECD developed definitions.

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23 For purposes of these rules, a financial arrangement may consist of rights and obligations (whether legal or equitable) under an arrangement that is cash settlable. An equity interest and an arrangement to provide or receive equity interests, will be characterised as a financial arrangement under the TOFA rules.

24 Section 974-130, ITAA 1997.

Board's consideration

4.33 The Board acknowledges the compliance difficulties that may arise where different jurisdictions adopt different definitions of 'financial instrument'. The OECD definition in the Action 2 Report has the advantage of being concise and simple, but the downside of this approach is that different jurisdictions may take different interpretations of what constitutes 'debt, equity and derivate instruments' under their local tax laws (including whether a substance or form approach is taken).

4.34 Notwithstanding these concerns, the Board is of the view that to maximise international harmonisation, the OECD's definition of 'financial instrument' in the Action 2 Report should be used in Australia's hybrid mismatch rules.

4.35 However, the Board recommends that the definition be clarified to note that for the purposes of the hybrid mismatch rules, the scope of the concepts of debt, equity and derivative instruments in the definition should be as determined under Australian accounting standards and accounting principles. As Australia's accounting standards are based on international accounting standards, limiting the scope of the definition to an internationally recognised accounting definition has the greatest chance of reducing cross-border interpretative differences. Such an approach should also reduce compliance costs for taxpayers, who will be able to identify potentially impacted arrangements by reference to their accounts.

4.36 The Board notes also that the existing 'financial arrangement' definition in the TOFA rules in Division 230 is intended to be similar in scope to the accounting standard definition of 'financial instrument' and that the current TOFA review project is expected to result in even greater alignment in the future. In time, the Board expects there will be greater alignment between the proposed definition and Australia's tax law definition.

4.37 It is likely that there will be some carve outs needed from the 'financial instrument' definition to ensure that certain types of instruments are not inadvertently caught by the rules. The exceptions from Division 230 may be an appropriate starting point when considering appropriate carve outs for the purposes of the hybrid mismatch rules. In particular, the Board is of the view that leases should be specifically carved out of the 'financial instrument' definition. These exceptions should be assessed as part of the legislative design process.

Recommendation 13.1

The Board recommends that to maximise international harmonisation, the OECD's definition of 'financial instrument' in the Action 2 Report should be used in Australia's hybrid mismatch rules.

However, the Board recommends that the definition be clarified to note that for the purposes of the hybrid mismatch rules, the scope of the definition should be limited to where the instrument is also a 'financial instrument' for the purposes of Australian accounting standards and accounting principles.

The Board recommends that leases be specifically carved out of the definition of a 'financial instrument'. Other carve outs may also be appropriate and should be considered as part of the legislative design process.

Structured arrangement

Background

4.38 Structured arrangement is defined in the Action 2 Report as 'any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.'[25] The primary definition in the Action 2 Report is then followed by a list of factors, any one of which may be indicative of a structured arrangement.

4.39 The test for what is a structured arrangement is objective and applies regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch.

4.40 Submissions generally did not comment specifically on the structured arrangement definition, however, a number of submissions did recommend that a widely held/ third party exemption should be included in the hybrid mismatch rules.

Board's consideration

4.41 In the Board's view, the concept of structured arrangement is broad in nature and its application is likely to give rise to interpretational difficulties in determining whether an arrangement would be caught by the hybrid mismatch rules. It is important that the scope and application of the hybrid mismatch rules is well defined to minimise compliance and uncertainty for both taxpayers and the ATO.

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25 Specific examples of structured arrangements are set out in OECD recommendation 10.2. Structured arrangement is relevant when applying OECD recommendations 1, 3, 4, 6 and 8.

4.42 The Board considers that the primary definition of 'structured arrangement' in the Action 2 Report is appropriate for Australia to adopt in its hybrid mismatch rules. However, the Board does not recommend including in that definition the secondary list of indicative factors suggested in the Action 2 Report, given their broad potential application. Instead, to the extent considered appropriate, certain of these indicative factors may be included in explanatory materials or ATO administrative guidance.

4.43 Although the Board does not recommend a specific 'widely held' or 'marketable securities' carve out, the Board notes that care should be taken in the development of legislation and ATO administrative guidance to clarify that, in general, such arrangements should not be captured by the definition of structured arrangement. This recognises the practical difficulty for issuers of these instruments to be able to determine in each investor's case the relevant tax treatment to determine if a mismatch arises.

Recommendation 13.2

The Board recommends that the concept of structured arrangement be clearly defined in its scope and be well supported by guidance material to ensure taxpayers are able to easily assess whether their arrangements would be caught by the hybrid mismatch rules.

Although the Board does not recommend a specific 'widely held' or 'marketable securities' carve out, the Board notes that care should be taken in the development of legislation and ATO administrative guidance to clarify that, in general, such arrangements should not be captured by the definition of structured arrangement.

OECD RECOMMENDATION 5

4.44 OECD recommendation 5 contains three specific recommendations for the tax treatment of reverse hybrids. These recommendations are not hybrid mismatch rules per se but rather are suggested improvements that could be made to the domestic tax law to reduce hybrid mismatch opportunities.

4.45 OECD recommendation 5 is optional for countries to adopt.

OECD recommendation 5.1- CFC regime

4.46 OECD recommendation 5.1 of the Action 2 Report recommends countries consider amending their existing CFC rules to ensure attribution of any ordinary income allocated to the taxpayer by a reverse hybrid (to eliminate any D/NI outcome).

4.47 A number of submissions received by the Board stated that the CFC aspects of OECD recommendation 5 should not be implemented by Australia. This was premised on the strength of Australia's existing CFC rules, acknowledgement by the

Government that our CFC rules already meet OECD best practice guidelines[26] and the view that our CFC rules (when combined with the hybrid mismatch rules) would appropriately deal with D/NI outcomes without the additional complexity of OECD recommendation 5.

4.48 It was further considered in one submission that, assuming the hybrid mismatch rules were introduced in a manner that gave them priority to other areas of the Australian tax law, the OECD recommendation 5 package of specific recommendations would not be necessary.

4.49 Submissions received by the Board generally did not comment on any other specific interaction issues with the CFC rules.

Board's consideration

4.50 The Australian CFC rules are considered robust and amongst some of the strongest globally.[27]

4.51 At present, there has been no empirical evidence presented to the Board that suggests there is an integrity risk to the Australian taxation base if the CFC aspects of OECD recommendation 5 were not implemented. While the Board has recommended implementation of the general reverse hybrid rule in OECD recommendation 4, the Board does not support implementation of the CFC aspects of OECD recommendation 5 where there is no significant integrity concern identified. This is consistent with the approach taken by the UK.

4.52 That said, the Board is of the view that, if a significant integrity concern arises in the future, the CFC aspects of OECD recommendation 5 should be reconsidered after the merits have been given further analysis. In doing so, the integrity risks should be weighed against the compliance and complexity in determining an appropriate response.

OECD RECOMMENDATIONS 5.2 AND 5.3

4.53 OECD recommendation 5.2 suggests limiting the tax transparency for non-resident investors. In this regard, the OECD noted that a reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the

26 A separate project was completed by the OECD as part of the BEPS project to design effective CFC rules (Action 3). The Australian CFC rules were found to meet OECD best practice, which was acknowledged by the Treasurer in a press release on 6 October 2015.

27 Note that the Treasurer's statement on our CFC rules meeting OECD best practice guidelines was in response to the OECD work conducted on Action 3: Strengthening CFC rules.

same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.

4.54 OECD recommendation 5.3 suggests that jurisdictions should introduce appropriate tax filing and information reporting requirements on persons established within their jurisdiction in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor.

Board's consideration

4.55 The Board does not consider it appropriate to adopt recommendations 5.2 and 5.3 at this stage. However, if significant integrity concerns or information gaps are identified in the future, implementation of OECD recommendation 5.2 and 5.3 should be reconsidered. In doing so, the integrity risks should be weighed against the compliance and complexity in determining an appropriate response.

Recommendation 14

The Board recommends that OECD recommendation 5 not be implemented immediately, but that it be left open to implement in the future if integrity concerns arise, and after the merits have been given further analysis.

INTERACTION WITH AUSTRALIA'S TAX TREATIES

4.56 Submissions did not identify any specific interaction issues between the hybrid mismatch rules and Australia's tax treaties. Similarly, there were no issues raised during consultation.

4.57 The Action 2 Report suggests adoption of Article 1(2) to deal with the tax treaty treatment of hybrid entities, expressly dealing with income derived from fiscally transparent entities or arrangements. This provision is reflected in the recently signed Australia-German tax treaty and expected to be incorporated by Australia in future treaty negotiations. Work by OECD Working Party 15 is continuing in relation to the development of a multilateral instrument under Action 15 of the BEPS project to implement treaty related measures and streamline the amendment of existing bilateral treaties.

Board's consideration

4.58 On the basis that no specific material issues have been identified in submissions or observed by the Board as part of its review, the Board has not made any specific recommendations in relation to the interaction with Australia's tax treaties.

CHAPTER 5: HYBRID REGULATORY CAPITAL

BACKGROUND

5.1 The Action 2 Report indicates that countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise from intra-group hybrid regulatory capital. This option was provided to address concerns that a number of regulators, such as the US, increasingly require financial institutions (such as banks) to issue regulatory capital externally at the top holding company level and then downstream lend this to operating subsidiaries. Absent an exception, intra-group regulatory capital legitimately issued as a result of these requirements could be caught within the hybrid mismatch rules.

5.2 The hybrid mismatch rules can also apply to regulatory capital issued to third parties in certain circumstances. In an Australian context, the Action 2 Report potentially impacts regulatory capital instruments issued by some Australian banks and insurers. In particular, some banks and insurers have issued Additional Tier 1 (AT1) capital out of a foreign branch (most commonly New Zealand) to Australian investors. Due to particular terms required to be included in AT1 issuances for regulatory purposes, AT1 issued by Australian regulated entities is classified as equity for Australian tax purposes. As such, returns paid on the AT1 instruments to the investors are frankable (and typically required to be fully franked by the issuer in accordance with the benchmark imputation rules). To the extent the return is unfranked, the investor will receive an increased cash return. In a number of foreign jurisdictions, AT1 is treated as debt for tax purposes (in line with the accounting and regulatory treatment) and a deduction is available for returns paid on AT1 to investors.[28]

5.3 Accordingly, where an Australian bank or insurer issues AT1 out of a foreign branch that recognises AT1 as debt for tax purposes, the instrument will pay a return that is deductible in that foreign jurisdiction and, whilst the return[29] is likely assessable to the Australian investor, that investor may receive a form of tax relief by way of a franking credit.

5.4 The Action 2 Report suggests that the interaction of the Australian imputation system can result in a D/NI outcome where a deduction is available in a foreign jurisdiction in respect of the frankable equity instrument — that is, because it is a

28 Jurisdictions which allow a deduction for returns paid on AT1 include, amongst others, New Zealand, the UK and, in some instances, Singapore.

29 The return being the cash return and the gross up amount for the imputation credit.

hybrid instrument.[30] As such, the Action 2 Report can potentially impact regulatory capital instruments in one of three ways:

1. if Australia adopts OECD recommendation 2.1, the hybrid mismatch rules may operate to deny a franking credit to Australian investors. OECD recommendation 2.1 is an optional recommendation that jurisdictions consider domestic law restrictions on access to any dividend exemption or other types of dividend relief to prevent a D/NI outcome arising under a financial instrument. Recommendation 2.1 has no scope limitations;

2. if Australia does not adopt OECD recommendation 2.1, the payer jurisdiction can apply the primary rule in recommendation 1 to deny a deduction for the AT1 return (where they have implemented OECD compliant hybrid mismatch rules). OECD recommendation 1 applies to financial instruments that are structured arrangements or that are issued between related parties; and

3. if 1 and 2 did not apply, Australia can apply the defensive rule in OECD recommendation 1 to deny the franking credit to the Australian investor.

5.5 The UK draft legislation provides a full exclusion, at least for now, from the hybrid mismatch rules for regulatory capital instruments issued by banks and insurers. HMRC did indicate that the UK Government will continue to review the regulatory capital position with any changes enacted through regulation at a later date.

VIEWS IN SUBMISSIONS

5.6 Submissions made in response to the Board's Consultation Paper note that an exclusion for hybrid regulatory capital instruments is required, based on a number of reasons, including that the arrangements are predominantly issued for regulatory and commercial reasons.

Economic impacts

5.7 A number of submissions voiced concern that, if the hybrid mismatch rules were to apply to hybrid regulatory capital instruments, the cost of capital for the Australian banking and insurance sector would increase.[31] This could have flow on implications to the extent these costs are passed onto consumers. During consultation, there were varying views amongst stakeholders on whether the increased costs would be

30 See example 2.1 of the Action 2 Report.

31 See IAG, ANZ and the joint submission by NAB, CBA, Westpac and Macquarie Bank.

significant enough to pass onto consumers once the additional costs are spread across the loans supported by deductible/frankable AT1 instruments.[32]

Franking credits — equivalent tax relief

5.8 Some submissions highlighted that OECD recommendation 2.1 is primarily aimed at hybrid financial instruments where the payee jurisdiction grants an exemption for the return. OECD recommendation 2.1 'encourages countries to consider introducing restrictions on the availability of other types of double taxation relief for dividends.' Paragraph 108 and example 2.1 of the Action 2 Report suggest that imputation credits may be equivalent tax relief for these purposes.

5.9 KPMG's submission noted that a recipient of an exempt dividend pays no further tax (regardless of profile), while a franked dividend can only be paid if the company has paid tax itself. Unlike an exemption system, franking credits represent a finite pool of credits representing previously paid domestic tax. Additional 'top up' tax may be payable by the investor depending on their marginal tax rate.

Compliance costs

5.10 Some stakeholders suggested that applying the hybrid mismatch rules to listed instruments would introduce significant administrative challenges. Because listed capital instruments are typically held by nominees, issuers may be unable to identify the beneficial owners of their capital instruments.

5.11 To alleviate this issue, if the hybrid mismatch rules applied, they would need to operate in a manner that rendered the instrument unfrankable where it was issued out of a foreign branch that grants a tax deduction, rather than denying the franking credit at the investor level.

Interactions with existing law

5.12 Application of the OECD recommendations to frankable/deductible AT1 may have significant interaction with other parts of Australia's tax laws and the laws of other jurisdictions. During consultation, some of the concerns raised by participants include:

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32 A number of stakeholders consulted cited a number of factors making the cost of capital more expensive (for example, increasing regulatory requirements), and that the application of hybrid mismatch rules would further add to these costs — the totality of which would be weighed in a decision on interest rates for customers.

1. the application of section 215-10[33] and the inability of Authorised Deposit taking Institutions (ADIs) to practically apply this provision in relation to offshore capital raisings out of foreign branches, and the inability of the insurance sector to access this provision;

2. franking streaming rules, which together with the benchmark rule, appears to contradict an exception for franking deductible equity issuances;

3. the fact that a deduction on regulated instruments in some overseas jurisdictions (notably the UK) can be limited to the regulatory capital needed to support activity in that jurisdiction, which can result in a deduction that is not static, and instead may fluctuate on a year by year basis. This will necessarily create complications in complying with any law which links the franking credit position to the question of deductibility in another jurisdiction; and

4. the ability of the issuer to identify when a deduction has been obtained given the inability to 'trace' any capital raisings funds, which are simply pooled with all other funds including deposits.

Level playing field

5.13 It is noted that not all banks and insurers are able to issue deductible/frankable AT1 instruments. The ability to issue such instruments is largely dependent on the size and tax profile of the issuers' offshore branches, and the restrictions in that offshore jurisdiction for granting a deduction.

5.14 In particular, the regional Australian banks have noted that they are at a competitive disadvantage in accessing a cheaper cost of funding as they do not have significant offshore branches through which they can issue AT1.

Grandfathering

5.15 Stakeholders were equally of the view that, if a carve out was not provided for hybrid regulatory capital instruments issued by Australian banking and insurance sector, the hybrid mismatch rules should be 'unequivocally prospective' in their operation and apply only to instruments issued on a date after the relevant legislation has been enacted by Parliament. In this respect, stakeholders stated that this transitional rule would provide an appropriate level of certainty about the status of instruments already on issue, avoid the difficulty and cost of potentially refinancing for

33 Section 215-10 operates to exempt ADIs from having to frank distributions for Tier 1 non-share equity issued at or through a permanent establishment in a listed country, where there funds from the issue are applied solely for a permitted purpose (broadly, this includes application of the funds for the business of the permanent establishment other than transfer of the funds to the Australian operations of the ADI).

issuers and unintended impacts on investors.[34] Concerns were raised around the ability for the domestic market to absorb multiple concurrent issuances for new AT1 instruments if grandfathering of existing AT1 arrangements was not granted, and resultant impact on refinancing costs.

5.16 The Board understands there are currently approximately $7.7 billion of deductible/frankable AT1 instruments on issue, out of a total AT1 issuance in the market of approximately $34 billion. In the joint NAB, CBA, Westpac and Macquarie Bank submission, the banks estimate that the increased cost of capital for deductible/frankable AT1 if the hybrid mismatch rules were to apply would be at least 100 to 150 basis points, but could be up to 200 basis points in some circumstances.[35]

Mills case

5.17 Deductible/frankable hybrid instruments were considered by the High Court of Australia in *Mills v Commissioner of Taxation* 2012 ATC 20-360.[36] The judgment considered the legislative history and policy of the imputation provisions and the anti-avoidance measures and unanimously concluded that there was no impermissible purpose in issuing the PERLS V. Importantly, the Court noted that the 'Bank equally obviously issued PERLS V because the Bank needed to raise Tier 1 capital in circumstances where all the means available to the Bank to raise Tier 1 capital would have involved the Bank franking distributions to the same extent and where PERLS V represented the most commercially attractive of those available means'.

Board's consideration

5.18 In considering the application of the hybrid mismatch rules to regulatory capital, consultation was undertaken with each of the major Australian banks, representatives from the regional banks, an insurer with issued deductible/frankable capital, and with Treasury.

5.19 Based on consultations, the Board understands that the full extent of market consequences for individual banks, insurers and for the broader economy will be difficult to predict with any certainty given the variables involved, including market conditions at the time of issuance and the different capital management strategies undertaken by individual banks and insurers.

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34 See the joint submission by NAB, CBA, Westpac and Macquarie Bank. Grandfathering for regulatory capital was also supported in a number of other submissions including ANZ, IAG and KPMG.

35 Being the gross up required where there was no available franking credit.

36 The Court was asked to consider whether Australia's anti-avoidance laws applied to the issue of 'PERLS V' (an acronym for 'Perpetual Exchangeable Resalable Listed Securities V') issued by the Commonwealth Bank of Australia on 14 October 2009 and traded on the Australian Securities Exchange. PERLS V was a hybrid security that was frankable under Australian taxation laws and deductible against the profits of the Bank earned in New Zealand.

5.20 Indications from Treasury are that the increased costs of capital for regulated entities who are no longer able to issue deductible/frankable AT1 instruments as a result of the hybrid mismatch rules is not likely to cause significant disruption to the market.

5.21 In addition, even if these additional costs are passed on to customers, Treasury suggest it is unlikely to have a material impact on pricing of loans to customers.

5.22 The Board's recommendation is set out below.

Recommendation 15

Deductible/frankable regulatory capital issuances can advantage banks and insurers with sufficient offshore operations and franking credit balances.

The Board considers that an appropriate policy response is one that provides, to the greatest extent possible, a level playing field between all regulated entities, allows for Australian regulated entities to diversify their sources of funding and minimises complexity, compliance and disruption to markets.

The application of the hybrid mismatch rules to regulatory capital would partially assist in achieving a more level playing field between all regulated entities. However, it may be possible to neutralise the hybrid mismatch outcomes of such arrangements in a manner which better facilitates a level playing field and goes further in achieving the other aims of diversification and minimising complexity, compliance and disruption. This would require a holistic review of Australia's tax treatment of regulatory capital, encompassing potential changes to section 215-10 and the franking streaming rules.

The Board recommends that further time be granted to consider the appropriate policy response to this matter given:

- the complexities and interactions involved;
- the limited time period in which this review was able to be undertaken, and
- the need to undertake a holistic review to assess and ensure unintended consequences do not arise.

The Board proposes to work with Treasury, the ATO and stakeholders to identify a workable solution. This further work will be undertaken as a matter of priority so that any commencement may align with the commencement date of the hybrid mismatch rules.

The Board notes that there are some strong arguments in favour of grandfathering or including transitional arrangements for existing deductible/frankable AT1 issuances from any changes ultimately recommended under this further review, to minimise market disruption and the impact on third party investors. Accordingly, the Board recommends appropriate grandfathering or transitional arrangements also be considered as part of the further review. Any cut-off date for grandfathering or transitional arrangements should be clearly defined to minimise any disruption for future AT1 issuances, including issuances that may be made during the further review period.

Chapter 6: Legislative Design

Legislative design

6.1 The Board sought views on the most appropriate legislative design approach to adopt to minimise the legislative complexity for taxpayers while ensuring that the hybrid mismatch rules are certain in their scope, application and effect.

6.2 The Tax Institute put the view forward that the hybrid mismatch rules 'should be drafted as tightly as possible and should use the existing apparatus of the law'. The Tax Institute also noted that 'consideration should be given as to whether rules should be inserted as a separate regime or could be included in Part IVA. Other 'priority' regimes should be considered when determining the priority operation of these rules.'

6.3 Other submissions also noted that consideration should be given to the interaction and ordering of the hybrid mismatch rules with other 'priority' regimes. It was noted that uncertainty on the ordering of the hybrid mismatch rules with other regimes could increase compliance costs for both taxpayers and administrators. Ernst & Young was of the view that the hybrid mismatch rules should apply in priority.

6.4 The Corporate Tax Association and Ernst & Young were similarly of the view that 'the best approach would be to introduce a principles based hybrid mismatch rule drafted in line with the stated policy objectives'. The Corporate Tax Association also 'recommended that any principles based hybrid mismatch rule be supplemented by appropriate guidance material from the ATO on how it proposes to administer its operation.'

Board's consideration

6.5 The Board considers that the hybrid mismatch rules should be supported by a stand-alone legislative framework and that the legislation be drafted as a separate and overarching regime in Australia's tax law.

6.6 The Board considers that a pure black letter drafting approach could give rise to significant complexity in the law. However, it is acknowledged that a principles based drafting approach can equally give rise to uncertainty in its application.

6.7 The Board recommends the legislation be predominately principles-based setting out the high-level policy and concepts underpinning the hybrid mismatch rules, but this should be coupled with more precise drafting for particular aspects of the hybrid mismatch rules which require clear boundaries to provide certainty in their application.

6.8 In terms of determining the priority of the hybrid mismatch rules in relation to other parts of Australia's tax law, the Board considers that, as a general rule, the hybrid mismatch rules should apply in priority to other parts of the tax law. This approach is intended to ensure taxpayers are not required to technically assess whether other integrity rules apply (such as transfer pricing) only to then be denied a deduction from the application of the hybrid mismatch rules.

6.9 The Board also considers there is merit in the ATO providing administrative guidance contemporaneously with the introduction of hybrid mismatch legislation to allow taxpayers to structure their affairs with certainty (and for draft administrative guidance to be made available at the same time as the draft legislation).

Recommendation 16

The Board recommends:

- the hybrid mismatch rules be drafted as a separate regime in Australia's tax law;
- a balance of principles-based drafting setting out the high-level policy underpinning the hybrid mismatch rules, coupled with more precise drafting for areas of the rules which require clear boundaries to provide certainty in their application;
- the hybrid mismatch rules apply in priority to all other parts of Australia's tax law; and
- the Commissioner provide detailed administrative guidance contemporaneously with the introduction of the hybrid mismatch legislation.

POST-IMPLEMENTATION REVIEW

6.10 It is entirely possible that Australia will be one of the earliest jurisdictions to legislate the hybrid mismatch rules. Different approaches and issues may be identified by other jurisdictions during review and implementation of their version of the hybrid mismatch rules. The Board understands that the OECD working group for the OECD Action 2 Report (Working Party 11) will continue to meet to discuss implementation progress, with a view to harmonisation between different regimes as best practice hybrid mismatch rules.

Board's consideration

6.11 Acknowledging that there is a possibility that Australia will be one of the first countries to implement the hybrid mismatch rules, the Board recommends that a post-implementation review of Australia's hybrid mismatch legislation be undertaken, preferably after a number of other jurisdictions have implemented hybrid mismatch rules.

6.12 This will provide an opportunity to ensure the greatest possible harmonisation with the hybrid mismatch rules across jurisdictions to help minimise compliance costs, uncertainty for taxpayers and eliminate any unintended consequences (such as incidences of double taxation). It will also enable a review of any interaction and implementation difficulties faced by Australian taxpayers in applying the hybrid mismatch rules in practice, including any unintended double taxation outcomes.

Recommendation 17

Acknowledging that there is a possibility that Australia will be one of the first countries to implement the hybrid mismatch rules, the Board recommends that a post-implementation review of Australia's hybrid mismatch legislation be undertaken, preferably after a number of other jurisdictions have implemented hybrid mismatch rules and in light of any further recommendations made or best practice approaches suggested by OECD Working Party 11 in relation to the implementation of the Action 2 Report.

GLOSSARY

AASB	Australian Accounting Standards Board
Action 2 Report	Neutralising the Effects of Hybrid Mismatch Arrangements of the BEPS Action Plan
ADI	Authorised Deposit-taking Institution
AmCham	American Chamber of Commerce in Australia
ANZ	Australia & New Zealand Banking Group
AT1	Additional Tier-1 Capital
ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
CBA	Commonwealth Bank of Australia
CFC	Controlled Foreign Company
Commissioner	Commissioner of Taxation
CTA	Corporate Tax Association of Australia
DD	Double deduction
Directive	Anti-Tax Avoidance Directive
D/NI	Deduction/No Inclusion
EC	The European Commission
EU	European Union
G20	The Group of Twenty
HMRC	HM Revenue & Customs
IAG	Insurance Australia Group Limited
MAAL	Multinational Anti-Avoidance Legislation

Macquarie Bank	Macquarie Group Limited
MRPS	Mandatory Redeemable Preference Share
NAB	National Australia Bank
OECD	Organization for Economic Co-operation and Development
PERLS V	Perpetual Exchangeable Resalable Listed Securities V
Regional banks	Bank of Queensland, Bendigo and Adelaide Bank and Suncorp Group
The Board	Board of Taxation
TOFA	Taxation of Financial Arrangements
UK	United Kingdom
US	United States
Westpac	Westpac Banking Group

APPENDIX A: OVERVIEW OF OECD HYBRID MISMATCH RECOMMENDATIONS

OVERVIEW OF THE OPERATION OF THE HYBRID MISMATCH RULES

The table below provides a summary of the hybrid mismatch rules which include a recommendation to neutralise hybrid mismatches.

Recommendation	Neutralising recommendation	Scope
Deduction/No Inclusion (D/NI) outcomes		
1. Hybrid financial instrument	**Primary rule** – Deny payer deduction to the extent of the D/NI outcome **Defensive rule** – Include in payee ordinary income to the extent of the D/NI outcome	Related persons and structured arrangements
2. Specific Hybrid financial instrument rule	Deny dividend exemption for deductible payments Limits withholding tax relief for hybrid transfer instruments	No scope limitation
3. Disregarded Hybrid Payments Rule	**Primary rule** – Deny payer deduction[37] **Defensive rule** – Include in payee ordinary income	Same control group and structured arrangements
4. Reverse Hybrid Rule	**Primary rule** – Deny payer deduction.	Same control group and structured arrangements
5. Specific Reverse Hybrid Rule	Specific recommendations to: - Improve CFC rules/offshore investment regimes - Limit tax transparency for non-resident investors - Introduce information reporting for intermediaries	No scope limitation
Deduction/Deduction (or Double Deduction DD) outcomes		
6. Deductible Hybrid Payment Rule	**Primary rule** – deny parent entity deduction **Defensive rule** – deny payer deduction	Defensive rule applies to same control group and structured arrangements
7. Dual Resident Payer Rule	**Primary rule** – deny parent entity deduction There is no defensive rule	No scope limitation
Indirect Deduction/No Inclusion D/NI outcomes		
8. Imported Mismatch rule	**Primary rule** – Deny payer deduction	Same control group and structured arrangements

37 To the extent it exceeds dual inclusion income (where the income is recognised in more than one jurisdiction – may include CFC income).

OECD RECOMMENDATION 1 — HYBRID FINANCIAL INSTRUMENT RULE

OECD recommendation 1 is intended to prevent taxpayers from entering into arrangements that exploit differences in the tax treatment of a financial instrument to produce a hybrid mismatch. A mismatch under a financial instrument arises when the payment made under a financial instrument is deductible under the laws of one jurisdiction (the payer jurisdiction) and not included in ordinary income by a taxpayer under the laws of another jurisdiction where the payment is received (payee jurisdiction).

OECD recommendation 1 applies to three different types of financing arrangements that give rise to a hybrid mismatch:

1. **Financial instruments** — this covers arrangements that are treated as debt, equity or derivative contracts. An example is a redeemable preference share issued by an Australian company which is treated as debt for Australian tax purposes and equity in the jurisdiction of the holder.

2. **Hybrid transfers** — this applies where entities in different jurisdictions are treated as the owner of the same asset for tax purposes. An example could be a securities lending arrangement where one jurisdiction treats the legal owner as the holder of the securities and another jurisdiction treats the economic owner as the holder of the securities.

3. **Substitute payments** — this covers where a payment is made in substitution for the financing or equity return on a transferred asset where the tax outcome undermines the integrity of the hybrid financial instrument rule.

A hybrid mismatch will only arise where the mismatch can be attributed to the terms of the financial instrument. OECD recommendation 1 is not intended to apply to mismatches:

- that are solely attributable to the status of the taxpayer e.g. tax exempt pension funds;
- that arise in respect of a payment made to a taxpayer in a purely territorial regime;[38] and
- that arise in respect of the circumstances in which the instrument is held.

38 A jurisdiction that excludes or exempts all foreign source income.

OECD RECOMMENDATION 2 — SPECIFIC RECOMMENDATIONS FOR THE TAX TREATMENT OF FINANCIAL INSTRUMENTS

OECD recommendation 2 provides the following two specific recommendations which are optional for countries to adopt:

- OECD recommendation 2.1 — Deny a dividend exemption or equivalent tax relief[39] for payments that are treated as deductible by the payer.
- OECD recommendation 2.2 — Limit the ability of a taxpayer to claim relief from foreign withholding tax on instruments that are held subject to a hybrid transfer.

There is no limitation on the scope of the recommendation 2. It can apply to any arrangement and not just structured arrangements or arrangements entered into between related parties.

Denial of dividend exemption for deductible payments

OECD recommendation 2.1 applies to deny the payee a dividend exemption or equivalent tax relief to the extent the payment is deductible to the payer. Where recommendation 2.1 is adopted by the payee jurisdiction (such that the payee is denied a dividend exemption), it should not be necessary for the payer jurisdiction to then apply recommendation 1 to deny a deduction, as any mismatch will have already been eliminated.

Australia currently provides a dividend exemption in Subdivision 768-A which may be impacted by the operation of recommendation 2.1. A number of countries including the UK, Japan, and the Netherlands have, or have announced, domestic rules which remove their dividend exemption for deductible payments. The EU have also issued a Directive to EU members stating that the tax exemption applied to distributed profits should be disallowed to the extent those profits are deductible by the subsidiary of the parent company.

Restriction of foreign tax credits under a hybrid transfer

OECD recommendation 2.2 sets out a rule to restrict foreign tax credits under a hybrid transfer, to align the availability of withholding tax relief with the economic benefit of the payment. This could arise under a securities lending arrangement where both the borrower and lender are treated as deriving the dividend income under their respective jurisdictions and both parties seek to claim withholding tax relief.

The rule would operate to restrict the amount of credit in proportion to the net taxable income of the payer under the arrangement.

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39 Equivalent tax relief may include domestic tax credits, foreign tax credits or dividends taxed at a reduced rate.

OECD recommendation 3 — Disregarded Hybrid Payments Rule

OECD recommendation 3 focuses on payments made by a hybrid payer. OECD ecommendation 3 requires the denial of a deduction to the payer.

A hybrid payer is any entity which makes a payment where the tax treatment under the laws of the payee jurisdiction causes the deductible payment[40] to be a disregarded payment. Payments which are disregarded only give rise to a hybrid-mismatch where they are available to set off an amount of income that is not recognised in both the payer and payee jurisdiction. There is no hybrid mismatch where the deduction offsets dual inclusion income — that is, income included in the income in both the payer and payee jurisdiction.

Any amount disallowed can be carried forward to be set off against dual inclusion income in another period.

OECD recommendation 4 — Reverse Hybrid Rule

Under OECD recommendation 4, a deductible payment made to a reverse hybrid may give rise to a mismatch in tax outcomes where that payment[41] is not included in ordinary income in the jurisdiction where the payee is established or in the jurisdiction of any investor in that payee. OECD recommendation 4 requires the denial of a deduction to the payer.

A reverse hybrid is any entity that is treated as transparent in the jurisdiction in which it is established, but treated as a separate opaque (taxable entity) by the investor jurisdiction. This type of entity is referred to as a reverse hybrid as it is the reverse of the more usual type of hybrid (where the establishment jurisdiction treats the entity as opaque and the investor jurisdiction treats the entity as transparent).

OECD recommendation 4 does not apply where a mismatch would not have arisen had the income been paid directly to the investor. Inclusion of a payment under a CFC regime will be treated as having been included in ordinary income for the purposes of the reverse hybrid rule.

OECD recommendation 4 will also not apply if inclusion of the payment is brought under OECD recommendation 5 to neutralise the mismatch.

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40 Deductible payments are not limited to interest payments and may include items such as rent, royalties and services payments.

41 Like the disregarded hybrid payments rule, the reverse hybrid rule applies to a broad range of deductible payments (but does not include capital allowances) — see footnote 12.

OECD RECOMMENDATION 5 — SPECIFIC RECOMMENDATIONS FOR THE TAX TREATMENT OF REVERSE HYBRIDS

Recommendation 5 sets out improvements to domestic laws that could be made to reduce the incidence of reverse hybrids, namely:

(a) **Recommendation 5.1 – amend the offshore investment (CFC) rules** to ensure attribution of any ordinary income allocated to the taxpayer by a reverse hybrid (to eliminate any NI outcome). Australia will need to determine whether and how its CFC rules should be amended to reflect this recommendation;

(b) **Recommendation 5.2 – 'switch off' tax transparent treatment in the establishment jurisdiction** (by treating the tax transparent vehicle as a resident taxpayer) where a tax transparent vehicle is controlled by a non-resident investor who will not be subject to tax on income allocated to that investor by the tax transparent vehicle (because it is not transparent in the investor's jurisdiction); and

(c) **Recommendation 5.3 – introduce tax filing and information reporting** to encourage appropriate and accurate records for tax transparent entities — that is, who their investors are, the size of each investor's investment and the amount of income and expenditure allocated to each investor.

OECD RECOMMENDATION 6 — DEDUCTIBLE HYBRID PAYMENTS RULE

DD outcomes may be triggered where a taxpayer makes a payment through a cross-border structure, such as a dual resident, a foreign branch or a hybrid person, and a deduction can be claimed for that expenditure in more than one jurisdiction. Recommendation 6 will only apply where there is a hybrid mismatch, so will not apply where there is also dual inclusion income offsetting the DD (income included as assessable in more than one jurisdiction).

An example is a US general partnership (GP) with Australian partners that is treated as opaque in the US (under the 'check the box' regime) and treated as transparent in Australia. The US GP is the top company of a US tax consolidated group and borrows funds from a third party lender and claims a deduction for the interest both in the US at the GP level and again at the Australian partner level.

The OECD acknowledges that determining which payments give rise to a DD and which items are dual inclusion income requires a comparison between the domestic tax treatment of these items and their treatment under the laws of the other jurisdiction. The Action 2 Report notes countries should decide whether they extend recommendations 6 and 7 (see below) to all deductible items regardless of whether they are attributable to a payment (for example, double tax depreciation claims).

OECD RECOMMENDATION 7 — DUAL RESIDENT PAYER RULE

OECD recommendation 7 applies to DD outcomes that arise because a dual resident entity is able to claim a deduction for a single economic expense in more than one jurisdiction. There is no mismatch to the extent the deduction is set-off against income that is included as income in both jurisdictions (dual inclusion income).

The rule recommends that both jurisdictions should apply the primary rule to restrict the deduction to dual inclusion income. Any excess can be carried forward to set-off dual inclusion income in another period.

OECD RECOMMENDATION 8 — IMPORTED MISMATCH RULE

The imported mismatch rule in OECD recommendation 8 is designed to prevent taxpayers from entering into structured arrangements or arrangements with group members in jurisdictions that have not introduced hybrid mismatch rules, to indirectly shift the tax advantage from the hybrid mismatch to a jurisdiction that has not applied the rules. This may be through the use of a non-hybrid instrument such as an ordinary loan.

The primary rule is that the payer jurisdiction should deny the deduction for any imported mismatch payment to the extent the payee treats the payment as set-off against a hybrid deduction in the payee jurisdiction.

Tracing and priority rules will need to apply to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement.[42]

OECD RECOMMENDATION 10, 11 AND 12 — DEFINITIONS

OECD recommendations 10, 11 and 12 provide definitions for jurisdictions to adopt for the purposes of applying the OECD recommendations in the Action 2 Report.

OECD recommendation 10 defines structured arrangement as 'any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch'.

OECD recommendation 11 provides that 'two persons are related if they are in the same control group or if one person has a 25 per cent investment in the other person or a third person holds a 25 per cent or greater investment in both.' The test measures

42 Paragraph 246 of the final Action 2 Report sets out the suggested priority rules ((1) structured imported mismatches, (2) direct imported mismatches, and (3) indirect imported mismatches).

both direct and indirect investment, which includes voting rights and the value of any equity interests. If two or more people act together in respect of the ownership or control of an investment, they are required to aggregate their ownership interests for purposes of the related party test.

OECD recommendation 11 further provides that two persons are in the same control group if they form part of the same consolidated group for accounting purposes, if they are treated as associated enterprises under Article 9 of the OECD Model Tax Convention 2014, if one person has a 50 per cent investment in the other or someone has a 50 per cent investment in both or if there is effective control (whether directly or indirectly).

OECD recommendation 12 of the Action 2 Report provides a suite of other definitions for jurisdictions to adopt as part of their hybrid mismatch rules.

APPENDIX B: LIST OF PUBLIC SUBMISSIONS

American Chamber of Commerce in Australia

ANZ

Corporate Tax Association of Australia

Ernst & Young

Insurance Australia Group Limited (IAG)

Joint submission: CBA, Macquarie Group, NAB and Westpac

KPMG

PwC

The Tax Institute

APPENDIX C: TERMS OF REFERENCE

1. The Board of Taxation (Board) is asked to undertake consultation on the implementation of new tax laws to neutralise hybrid mismatch arrangements (anti-hybrid rules), pursuant to the recommendations of the G20 and OECD under Action Item 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan.

2. The Board is asked to examine how best to implement anti-hybrid rules in the Australian legal context. In particular, the Board should identify an implementation strategy that has regard to:

   - Delivering on the objectives of eliminating double non-taxation, including long term tax deferral;

   - Economic costs for Australia;

   - Compliance costs for taxpayers; and

   - Interactions between Australia's domestic legislation (for example, the debt-equity rules and regulated capital requirements for banks), international obligations (including tax treaties) and the new anti-hybrid rules.

3. The Board should conduct targeted consultation with relevant parties. We ask that the Board utilise its extensive links with tax professionals and key business groups. The Board should also work closely with Treasury and Australian Taxation Office in preparing its advice.

4. Further, the advice should utilise and build upon the conclusions of the Board's recent review of Australia's debt/equity rules and its consultation with businesses about their perspective on the G20/ OECD BEPS Action Plan.

5. The Board is requested to report to Government by March 2016 to allow this issue to be considered as part of the 2016 Budget.