
TREASURY LAWS AMENDMENT (OECD HYBRID MISMATCH RULES)
BILL 2018

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
APRA	Australian Prudential Regulation Authority
G20	Group of 20 — comprising Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MYEFO	Mid-Year Economic and Fiscal Outlook
OECD	Organisation for Economic Co-operation and Development
OECD Action 2 Report	OECD report on <i>Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report</i>
OECD Branch Mismatch Arrangements Report	OECD report on <i>Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS</i>
PE	Permanent establishment
TOFA	Taxation of financial arrangements

Chapter 1

OECD hybrid mismatch rules

Outline of chapter

1.1 Schedule 1 to this Bill amends the ITAA 1997 to prevent entities that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries.

1.2 All references in this chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.3 In 2015, as part of the OECD/G20 Base Erosion and Profit Shifting Project, the OECD released the OECD Action 2 Report which makes recommendations to neutralise the effects of hybrid mismatch arrangements.

1.4 In the 2015-16 Budget, the Government asked the Board of Taxation to consult on the implementation of the OECD hybrid mismatch rules. The Board completed its Report on the *Implementation of the OECD Hybrid Mismatch Rules* in March 2015.

1.5 In the 2016-17 Budget, the Government announced that it would implement the recommendations made in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation.

1.6 In the 2017-18 Budget, the Government further announced that it would eliminate hybrid tax mismatches that occur in cross border transactions relating to Additional Tier 1 regulatory capital. Transitional rules for Additional Tier 1 capital instruments issued before 9 May 2017 were also announced. Chapter 3 explains these changes.

1.7 In 2017, the OECD released the OECD Branch Mismatch Arrangements Report which makes recommendations to neutralise the effects of branch mismatch arrangements.

1.8 In the 2017-18 MYEFO, the Government announced an extension of the OECD hybrid mismatch rules to:

- implement the recommendations in the OECD Branch Mismatch Arrangements Report; and

- introduce a targeted integrity rule to prevent multinational groups from being able to enter into arrangements designed to circumvent the hybrid mismatch rules.

1.9 In broad terms, hybrid mismatch arrangements arise where entities exploit differences in the taxation treatment of an entity or instrument under the laws of at least two tax jurisdictions to defer or reduce income tax. This can result in double non-taxation, including long term tax deferral.

1.10 The types of hybrid mismatch arrangements are deduction/deduction arrangements and deduction/non-inclusion arrangements.

- A deduction/deduction mismatch occurs when a business receives a deduction in two countries for the same payment.
- A deduction/non-inclusion mismatch occurs when a deduction is provided for a payment in one country, but the corresponding income is not included as assessable income in the recipient country.

1.11 A simple example of a deduction/non-inclusion hybrid mismatch is a financial instrument that is treated as:

- debt in one country, usually providing the issuer with a deduction for any interest paid; and
- equity in another country, usually providing the holder with an exemption for any dividends received from the other country.

1.12 Hybrid mismatches are a significant problem for the tax system when an arrangement involves related parties or is deliberately structured to result in a mismatch because it provides an opportunity to eliminate taxes that would otherwise be payable on business income unrelated to the arrangement.

1.13 Hybrid mismatch arrangements can reduce the collective tax base of countries around the world even though it can be difficult to determine which country has lost tax revenue.

1.14 The principal objective of the hybrid mismatch rules is to neutralise the effects of hybrid mismatches so that unfair tax advantages do not accrue for multinational groups as compared with domestic groups.

1.15 In this regard, the OECD Action 2 Report concludes that hybrid mismatch arrangements are widespread and result in a substantial erosion of the tax bases of countries concerned, with an overall negative impact on competition, efficiency, transparency and fairness. The OECD and the G20 considered the approach recommended in the OECD Action 2 Report

to be the only comprehensive and coherent way to tackle global tax avoidance and to discourage uncompetitive tax arbitrage.

1.16 The OECD Action 2 Report sets out comprehensive rules for dealing with hybrid mismatch arrangements. The amendments in this Bill closely follow the recommendations in the OECD Action 2 Report. Some departures occur principally to take into account recommendations of the Board of Taxation and to allow for unique features of the Australian tax system that were not specifically contemplated by the OECD recommendations. In this regard, key departures from the recommendations in the OECD Action 2 Report are:

- a modification to the hybrid financial instrument mismatch rule so that (as recommended by the Board of Taxation) the rule does not apply where, broadly:
 - the term of the arrangement is three years or less; and
 - the mismatch is merely one of timing;
- where the hybrid mismatch rules operate to neutralise a hybrid financial instruments mismatch by denying a deduction or including an amount in assessable income, allowing an adjustment to be made in a later income year to offset the neutralising amount in certain circumstances (as recommended by the Board of Taxation);
- no amendments are included to modify the domestic law to specify the treatment of reverse hybrids as outlined in Recommendation 5 of the OECD Action 2 Report (as recommended by the Board of Taxation); and
- the inclusion of an integrity rule to prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed no or low tax country conduit type vehicles to invest into Australia, as an alternative to investing directly into Australia via traditional hybrid instruments or entities.

1.17 The OECD Branch Mismatch Arrangements Report makes further recommendations to address mismatches that arise through the use of branch structures. Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. In this regard, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to a branch because of the different tax treatment in each country.

1.18 The hybrid mismatch rules in this Bill neutralise the effects of hybrid mismatches (including branch mismatches) by modifying the

outcomes that arise under the Australian income tax law. In some circumstances the modification of the Australian income tax outcome is subject to whether the effect of the mismatch has been neutralised under the taxation law in a foreign jurisdiction. This aligns with the OECD's recommended ordering of primary response and secondary response hybrid mismatch provisions.

1.19 It is likely that, where possible, many taxpayers will restructure out of hybrid arrangements and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules. It is possible that restructures which remove a hybrid mismatch could result in:

- retaining a deduction in foreign jurisdiction with a greater amount being included in the Australian income tax base — either because of the elimination of an Australian income tax deduction or an increase in assessable income;
- retaining an exemption in a foreign jurisdiction with a greater amount being included in the Australian income tax base because of the elimination of an Australian income tax deduction; or
- retaining a deduction with a greater amount being included in a foreign income tax base.

1.20 Either of these neutralising outcomes would satisfy the objective of the hybrid mismatch rules.

1.21 A targeted integrity rule will prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed conduit type vehicles to invest into Australia, as an alternative to investing directly into Australia via traditional hybrid instruments or entities. Without the integrity rule, these structures can be used to effectively retain a deduction/non-inclusion outcome.

1.22 Therefore, regard should be had to the potential application of this targeted integrity rule where there are intra-group financing arrangements within multinational groups involving:

- routing of funds through foreign interposed entities which result in an Australian income tax deduction (such as interest on a loan); and
- the imposition of foreign income tax on the payment at a rate of 10 per cent or less.

1.23 A number of other countries have taken steps to implement laws that give effect to the recommendations in the OECD Action 2 Report, or have made a commitment to implement laws that have this effect.

- The United Kingdom enacted laws to address hybrid mismatch arrangements with effect from 1 January 2017.
- New Zealand has introduced laws to address hybrid mismatch arrangements. These laws will apply to income years commencing on or after 1 July 2018.
- European Union member states have committed to apply hybrid mismatch rules by 1 January 2020.

Summary of new law

1.24 Schedule 1 to this Bill amends the ITAA 1997 by inserting the OECD hybrid mismatch rules into Division 832.

1.25 These rules will prevent entities (including multinational corporations) that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries.

1.26 The rules implement the recommendations in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation.

1.27 Broadly, a hybrid mismatch will arise if:

- an entity enters into a scheme that gives rise to a payment; and
- the payment gives rise to:
 - a deduction/non-inclusion mismatch; or
 - a deduction/deduction mismatch.

1.28 A mismatch will be covered by the hybrid mismatch rules if it is:

- a hybrid financial instrument mismatch;
- a hybrid payer mismatch;
- a reverse hybrid mismatch;
- a branch hybrid mismatch;
- a deducting hybrid mismatch; or
- an imported hybrid mismatch.

1.29 If a mismatch arises, it is neutralised by:

- disallowing a deduction; or

- including an amount in assessable income.

1.30 A targeted integrity rule will prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed country conduit type vehicles to invest into Australia, as an alternative to investing directly into Australia via traditional hybrid instruments or entities.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>The hybrid mismatch rules will prevent entities that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries. Broadly, a hybrid mismatch will arise if:</p> <ul style="list-style-type: none"> • an entity enters into a scheme that gives rise to a payment; and • the payment gives rise to: <ul style="list-style-type: none"> – a deduction/non-inclusion mismatch; or – a deduction/deduction mismatch. <p>A mismatch will be covered by the hybrid mismatch rules if it is:</p> <ul style="list-style-type: none"> • a hybrid financial instrument mismatch; • a hybrid payer mismatch; • a reverse hybrid mismatch; • a branch hybrid mismatch; • a deducting hybrid mismatch; or • an imported hybrid mismatch. <p>If a mismatch arises, it is neutralised by:</p> <ul style="list-style-type: none"> • disallowing a deduction; or • including an amount in assessable income. <p>A targeted integrity rule will prevent the effect of the hybrid mismatch rules to neutralise double</p>	<p>Entities can exploit differences in the taxation treatment of an entity or instrument under the laws of at least two tax jurisdictions by entering into hybrid mismatch arrangements designed to defer or reduce income tax. This can result in double non-taxation, including long term tax deferral.</p>

non-taxation outcomes from being compromised by multinational groups using interposed country conduit type vehicles to invest into Australia, as an alternative to investing directly into Australia via traditional hybrid instruments or entities.	
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Detailed explanation of new law

1.31 Schedule 1 to this Bill amends the ITAA 1997 by inserting the hybrid mismatch rules into Division 832.

1.32 A hybrid mismatch arises if double non-taxation results from the exploitation of differences in the tax treatment of an entity or financial instrument under the laws of two or more countries. There is double non-taxation if:

- a deductible payment is not included in a tax base; or
- a payment gives rise to two deductions.

[Schedule 1, item 1, section 832-1]

1.33 Disallowing a deduction, or including an amount in assessable income neutralises this tax advantage. *[Schedule 1, item 1, section 832-1]*

1.34 The rules in Division 832 are based on the OECD Action 2 Report. *[Schedule 1, item 1, section 832-1]*

When do the hybrid mismatch rules apply?

An entity must make a payment to a recipient

1.35 The hybrid mismatch rules in Division 832 apply if an entity (the payer) makes a payment to another entity (the recipient). The existence of a payment underpins the Division 832 hybrid mismatch rules. A payment involves the transfer of value from the payer to the recipient. It does not include a deemed or notional payment that is recognised solely for taxation purposes and that does not involve the creation of economic rights between the payer and the recipient.

1.36 In this regard, if a payment is made to two or more recipients, then the hybrid mismatch rules apply as if each part of the payment made to each such recipient were a separate payment. *[Schedule 1, item 1, subsection 832-25(2)]*

1.37 The hybrid mismatch rules apply in relation to a payment whether or not the scheme under which the payment is made has been or is entered into or carried out:

- in Australia;
- outside Australia; or
- partly in Australia and partly outside Australia.

[Schedule 1, item 1, section 832-40]

1.38 A *scheme* is defined in subsection 995-1(1) to mean:

- any arrangement; or
- any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

1.39 The identification of the scheme is determined having regard to the facts and circumstances of a particular case. In this regard, a particular scheme can be very broad to cover multiple entities and multiple periods of time. Alternatively, a particular scheme can be relatively narrow to cover a single entity and a single period of time.

The recipient has an entitlement to a payment, or is entitled to receive a non-cash benefit

1.40 The hybrid mismatch rules will also apply to an entity (the payer) if:

- another entity (the recipient) is entitled to receive a payment from the payer; or
- the recipient received a non-cash benefit from the payer — that is, for example, the payer provided services to the recipient.

[Schedule 1, item 1, section 832-10 and section 832-15]

Losses that arise from payments

1.41 The hybrid mismatch rules apply to a loss in the same way as they apply to a payment if:

- the loss gives rise to:
 - an Australian income tax deduction for an entity (the payer) for an income year; or
 - a foreign income deduction for an entity (also the payer) for a foreign tax period that starts in the income year; and
- the loss consists of all or part of a payment that will be made to another entity (the recipient) in a later income year.

[Schedule 1, item 1, section 832-20]

1.42 Note that section 832-850 affects losses from financial arrangements that are subject to the TOFA rules in Division 230.

1.43 A **foreign tax period**, in relation to an entity, in relation to a foreign tax imposed by a tax law of a foreign country, means the accounting period used by the entity for the purposes of determining the tax base under that law. [*Schedule 1, item 8, definition of 'foreign tax period' in subsection 995-1(1)*]

1.44 By applying the hybrid mismatch rules to a loss in the same way as they apply to a payment, the hybrid mismatch rules will apply to an amount that is deductible as it accrues (as distinct from when it is paid). In this instance:

- the entity with the loss will be the payer; and
- the entity that will be entitled to receive all or part of the payment in a later year will be the recipient.

Example 1.1: Accrual deductions are payments

Aus Sub issues a debt instrument to its shareholder which is repayable in 5 years. Interest accrues monthly but payment is contingent on Aus Sub's cash reserves.

At the end of Year 1, Aus Sub has accrued interest of \$100 but has not yet paid (or capitalised) the amount.

The accrued interest is a loss that is subject to the hybrid mismatch rules in the same way as they apply to a payment.

Certain tax provisions disregarded in identifying entities, income or profits, and payments

1.45 A number of provisions in the hybrid mismatch rules refer to an entity making a payment. To avoid doubt, whether an entity makes a payment to another entity is worked out disregarding:

- the single entity rule (subsection 701-1(1)) that applies for the purposes of Australia's tax consolidation regime;
- Part IIIB of the ITAA 1936 (which contains special rules for Australian branches of foreign banks); and
- any law of a foreign country that, for the purposes of a foreign tax, treats a different entity as having made a payment, or disregards a payment (such as a foreign law that has a similar effect to the single entity rule under Australia's tax consolidation regime).

[*Schedule 1, item 1, subsection 832-30(1)*]

1.46 Similarly, a number of provisions in the hybrid mismatch rules refer to the income or profits of an entity. To avoid doubt, these entities, and their income or profits, are also to be identified disregarding:

- the single entity rule (subsection 701-1(1)) that applies for the purposes of Australia's tax consolidation regime;

- Part IIIB of the ITAA 1936 (which contains special rules for Australian branches of foreign banks); and
- any law of a foreign country that, for the purposes of a foreign tax, treats those income or profits as income or profits of a different entity.

[Schedule 1, item 1, subsection 832-30(2)]

1.47 As a consequence of paragraph 832-30(2)(a), a member of an Australian tax consolidated group may be a hybrid payer (under section 832-330) or a deducting hybrid (under section 832-590). However, because of subparagraph 832-430(2)(b)(ii), it cannot be a reverse hybrid.

1.48 For all other purposes in the hybrid mismatch rules, the single entity rule is not disregarded. *[Schedule 1, item 1, section 832-35]*

1.49 This means that, for example, if a hybrid mismatch arrangement involves a member of a consolidated group, a mismatch will be neutralised by:

- disallowing a deduction for the head company of the group;
or
- including an amount in head company's assessable income.

Example 1.2: Disregarding the single entity rule when identifying payments

Aus Sub, a member of an Australian consolidated group, borrows money from another subsidiary member of the same tax consolidated group and pays interest on the borrowing. The single entity rule would ordinarily apply so that the payment is not recognised as a deduction or as assessable income for Australian income tax purposes.

However, the single entity rule is disregarded for the purposes of determining whether there is a payment to which the hybrid mismatch rules could apply.

As a result, for the purpose of determining whether there is a hybrid mismatch, the interest paid by Aus Sub is recognised as a payment.

Relationship between the hybrid mismatch rules and other charging provisions

1.50 If an amount is included in the assessable income of an entity under the hybrid mismatch rules in relation to a payment, then the amount that is included in assessable income under another provision of the Australian income tax law is reduced to the extent (if any) necessary to ensure that the total amount included in the entity's assessable income in relation to the payment does not exceed the amount of the payment.

[Schedule 1, item 1, subsections 832-45(1) and (2)]

1.51 Section 832-45 applies despite section 230-20 (which is about TOFA). *[Schedule 1, item 1, subsection 832-45(3)]*

Concepts relating to mismatches

1.52 A number of core concepts apply throughout the hybrid mismatch rules. These core concepts primarily relate to rules about identifying:

- deduction/non-inclusion mismatches; and
- deduction/deduction mismatches.

[Schedule 1, item 1, section 832-95]

1.53 These core concepts are:

- deduction/non-inclusion mismatch;
- deduction/deduction mismatch;
- foreign income tax deduction;
- subject to Australian income tax; and
- subject to foreign income tax.

Deduction/non-inclusion mismatch

1.54 A payment gives rise to a ***deduction/non-inclusion mismatch*** if:

- an Australian income tax deduction (other than a deduction that is solely attributable to a currency exchange rate effect) is allowable to an entity in an income year in respect of the payment (including a part or share of the payment); and
- the amount of the deduction exceeds the sum of the amounts of the payment that are:
 - subject to foreign income tax in a foreign country in a foreign tax period that ends no later than 12 months after the end of the income year; or
 - subject to Australian income tax for that income year.

[Schedule 1, items 1 and 8, subsection 832-100(1) and the definition of 'deduction/non-inclusion mismatch' in subsection 995-1(1)]

1.55 In these circumstances, the Australian income tax deduction is the deduction component of the deduction/non-inclusion mismatch to which the payment gives rise. *[Schedule 1, item 1, subsection 832-100(1)]*

1.56 A currency exchange rate effect is defined in section 775-105 to mean:

- any currency exchange rate fluctuations; or

- a difference between an expressly or implicitly agreed currency exchange rate for a future date or time and the applicable currency exchange rate at that date or time.

1.57 A payment also gives rise to a ***deduction/non-inclusion mismatch*** if:

- an entity is entitled to a foreign income tax deduction in a foreign tax period in respect of the payment (including a part or share of the payment);
- the amount of the foreign income tax deduction exceeds the sum of the amounts of the payment that are:
 - subject to foreign income tax in a foreign country in a foreign tax period that ends no later than 12 months after the end of the foreign tax period in which the foreign income tax deduction arose; or
 - subject to Australian income tax for an income year that ends no later than 12 months after the end of the foreign tax period in which the foreign income tax deduction arose; and
- the foreign income tax deduction is not solely attributable to:
 - any currency exchange rate fluctuations; or
 - a difference between an expressly or implicitly agreed currency exchange rate for a future date or time and the applicable currency exchange rate at that date or time.

[Schedule 1, items 1 and 8, subsection 832-100(2) and the definition of 'deduction/non-inclusion mismatch' in subsection 995-1(1)]

1.58 In these circumstances, the foreign income tax deduction is the deduction component of the deduction/non-inclusion mismatch to which the payment gives rise. *[Schedule 1, item 1, subsection 832-100(2)]*

1.59 Consistent with the approach in paragraph 54 of the OECD Action 2 Report, differences that arise solely as a result of foreign currency exchange movements are not intended to be captured as part of a deduction/non-inclusion mismatch.

1.60 The amount of the deduction/non-inclusion mismatch is the amount of the excess worked out under paragraph 832-100(1)(b) or (2)(b). *[Schedule 1, item 1, subsection 832-100(3)]*

1.61 In this regard, in working out whether a payment gives rise to a deduction, the effects of Division 832 (which operates to deny a deduction in appropriate circumstances) should be disregarded. *[Schedule 1, item 1, section 832-110]*

Deduction/deduction mismatch

1.62 A payment gives rise to a ***deduction/deduction mismatch*** if the payment, or part or share of the payment:

- gives rise to a foreign income tax deduction in a foreign country (the first country); and
- also gives rise to:
 - an Australian income tax deduction in an income year; or
 - a foreign income tax deduction in a foreign country (other than the first country).

[Schedule 1, items 1 and 8, subsection 832-105(1) and the definition of ‘deduction/deduction mismatch’ in subsection 995-1(1)]

1.63 Each of the following is a deduction component of the deduction/deduction mismatch:

- the foreign income tax deduction mentioned in paragraph 832-105(1)(a); and
- the Australian income tax deduction mentioned in subparagraph 832-105(1)(b)(i) or the foreign income tax deduction mentioned in subparagraph 832-105(1)(b)(ii), as the case requires.

[Schedule 1, item 1, subsection 832-105(2)]

1.64 The amount of the deduction/deduction mismatch is the lesser of:

- the amount of the foreign income tax deduction mentioned in paragraph 832-105(1)(a); and
- the sum of the amounts of the Australian income tax deduction, or the foreign income tax deduction, mentioned in subparagraph 832-105(1)(b)(i) or (ii).

[Schedule 1, item 1, subsection 832-105(3)]

1.65 For the purposes of identifying a deduction/deduction mismatch, section 832-105 applies in relation to the following amounts in the same way that it applies to a payment:

- an amount representing the decline in value of an asset;
- an amount representing a share in the net loss of a partnership, trust or other transparent entity.

[Schedule 1, item 1, subsection 832-105(4)]

1.66 For these purposes, a reference in the OECD hybrid mismatch rules to the scheme under which a payment is made is taken to be a reference to:

- if the amount represents the decline in value of an asset — the scheme under which the asset is held;
- if the amount represents a share in the net loss of a partnership, trust or other transparent entity — the scheme under which the net loss arose.

[Schedule 1, item 1, subsection 832-105(5)]

1.67 A deduction/deduction mismatch does not arise simply because:

- a part or a share of a payment gives rise to a deduction; and
- another part or share of that payment also gives rise to a deduction.

1.68 For example, partners in a general law partnership do not have a deduction/deduction mismatch merely because they each receive a deduction in respect of their share of an expense, by virtue of being in a partnership. However, partners in a partnership may have a deduction/deduction mismatch if other hybridity factors are present (for example, where the share of a partnership expense gives rise to both an Australian income tax deduction and also a foreign income tax deduction).

Foreign income tax deduction

1.69 An amount of a loss or outgoing incurred by an entity is a ***foreign income tax deduction*** in a foreign country in a foreign tax period if the entity is entitled to deduct the amount in working out its tax base for the foreign tax period under a law of the foreign country dealing with foreign income tax (except for credit absorption tax, unitary tax or a withholding-type tax). *[Schedule 1, items 1 and 8, subsection 832-115(1) and the definition of ‘foreign income tax deduction’ in subsection 995-1(1)]*

1.70 To avoid doubt, an amount of a loss or outgoing may be a foreign income tax deduction in a foreign country in a foreign tax period even if the entity’s tax base is nil or a negative amount. *[Schedule 1, item 1, subsection 832-115(2)]*

1.71 An amount is taken to be deducted in working out the tax base of an entity under a law in the foreign country for the foreign tax period if it is applied to reduce the amount of tax payable by the entity in the foreign country in any way. This could include, for example:

- an amount that specifically reduces the amount of tax payable by the entity in the foreign country (akin to an amount that is a deduction under the Australian income tax law); or
- an amount that is an element in the calculation by the entity of a net amount that is included in the tax base under the law in the foreign country.

1.72 In determining whether an entity is entitled to deduct an amount in working out its tax base for a foreign tax period under a law of the foreign country:

- the effect of any provisions of foreign hybrid mismatch rules of a foreign country should be disregarded; and
- the effect of any provisions of another law of a foreign country relating to foreign income tax (except for credit absorption tax, unitary tax or a withholding-type tax) that has substantially the same effect as Australia's foreign hybrid mismatch rules should be disregarded

[Schedule 1, item 1, subsection 832-115(3)]

1.73 This assumption will ensure the primacy of Australia's primary response provisions by enabling the deduction/non-inclusion or deduction/deduction mismatch to be identifiable. However, the assumption is modified for the purposes of Australia's secondary response provisions.

1.74 **Foreign hybrid mismatch rules** are rules under a foreign law that correspond to Australia's hybrid mismatch rules in Division 832.

[Schedule 1, item 8, definition of 'foreign hybrid mismatch rules' in subsection 995-1(1)]

1.75 In this regard, a foreign law will correspond to Australia's hybrid mismatch rules in Division 832 only if that law is consistent with the effect of the recommendations of the OECD Action 2 Report. Whether provisions of a foreign law have substantially the same effect as foreign hybrid mismatch rules will need to be determined at the time of the mismatch. For example, if another country has a rule that denies deductions for duplicate losses this could be considered substantially similar to foreign hybrid rules relating to deduction/deduction mismatches.

1.76 For the purposes of applying Division 832, it may be necessary to translate a foreign currency amount for a foreign income tax deduction into Australian currency.

1.77 In this regard, section 960-50 contains special translation rules that apply when an amount in a foreign currency is to be translated into Australian currency. Item 11A of the table in subsection 960-50(6) provides that, in circumstances where another item of the table does not apply to an amount, the amount is to be translated into Australian currency at the exchange rate that is reasonable in the circumstances (see Regulation 960-50.01 of the *Income Tax Regulations 1997*).

1.78 To avoid doubt, if a provision of Division 832 would require the amount of a foreign income tax deduction to be compared with another

amount, it is reasonable for the purposes of item 11A of the table in subsection 960-50(6) (as modified by the regulations) to:

- if the other amount is also to be translated into Australian currency — apply the exchange rate applicable at the same time as both translations; or
- if the other amount is denominated in Australian currency — apply the exchange rate applicable at the time the other amount is recognised under the Australian income tax law.

[Schedule 1, item 1, subsection 832-115(4)]

Subject to Australian income tax

1.79 An amount of income or profits is ***subject to Australian income tax*** in an income year if it is an amount that is included in an entity's assessable income for the income year. *[Schedule 1, items 1 and 8, subsection 832-120(1) and the definition of 'subject to Australian income tax' in subsection 995-1(1)]*

1.80 However, if the entity is a trust or partnership that has net income for the income year, then the amount is subject to Australian income tax to the extent that it reasonably represents an amount included in the assessable income of another entity for the income year (other than the entity that is the partnership or the trustee of the trust). *[Schedule 1, item 1, subsection 832-120(2)]*

1.81 An amount of income or profits of an entity is also taken to be subject to Australian income tax if the amount is included in the assessable income of another entity under the controlled foreign company regime (section 456 and 457 of the ITAA 1936). *[Schedule 1, item 1, subsection 832-940(3)]*

1.82 An amount included as a net capital gain would be regarded as subject to Australian income tax to the extent that it is included in the assessable income of an entity. For example, for a capital gain that is a discount capital gain, only that part of the capital gain that is included in assessable income would be regarded as being subject to Australian income tax.

Subject to foreign income tax

1.83 An amount of income or profits is ***subject to foreign income tax*** in a foreign country in a foreign tax period if foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) is payable under a law of the foreign country in respect of the amount because the amount is included in the tax base of that law for the foreign tax period. *[Schedule 1, items 1 and 8, section 832-125 and the definition of 'subject to foreign income tax' in subsection 995-1(1)]*

1.84 To avoid doubt, an amount of income or profits may be subject to foreign income tax in a foreign country in a foreign tax period even if the relevant entity's tax base is nil, or a negative amount. [*Schedule 1, item 1, subsection 832-125(2)*]

1.85 Therefore, an amount is regarded as being included in the tax base of a law of a foreign country even if the entity applies losses, outgoings or foreign tax credits against the amount to reduce its tax payable.

1.86 In addition, a capital receipt would be regarded as subject to foreign tax to the extent the foreign law included it in its determination of the entity's tax base.

1.87 However, an amount in relation to a payment would not be regarded as being subject to foreign income tax if, for example:

- a foreign law does not impose tax on the type of payment (such as a territorial regime that exempts foreign source income); or
- a foreign law subjects the type of payment to a tax rate of zero per cent.

1.88 If an entity is entitled under the law of a foreign country to a credit, rebate or other tax concession in respect of an amount of income or profits (the pre-credit amount) for foreign tax (other than a withholding-type tax) payable under a tax law of a different country (including Australia), only so much of the pre-credit amount as reasonably represents an amount not effectively sheltered from foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) by the credit, rebate or other tax concession is subject to foreign income tax. [*Schedule 1, item 1, subsection 832-125(3)*]

1.89 In addition, if an amount (the pre-deduction amount) consists of a dividend received by an entity from a company and the entity is entitled to a foreign income tax deduction in respect of all or part of the dividend, only so much of the pre-deduction amount as reasonably represents an amount not effectively sheltered from foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) by the foreign income tax deduction is subject to foreign income tax. [*Schedule 1, item 1, subsection 832-125(4)*]

1.90 Consequently, for a recipient resident in a country with a dividend received deduction system, only so much of the dividend income that is not reduced by the dividend received deduction would be subject to foreign income tax.

1.91 An amount of income or profits of an entity is taken to be subject to foreign income tax if the amount is included in working out the tax base of another entity under a provision of a law of a foreign country

that corresponds to Australia's controlled foreign company regime (Part X of the ITAA 1936) (including a tax base that is nil, or is a negative amount). *[Schedule 1, item 1, subsection 832-125(5)]*

1.92 In determining whether a payment is included in a tax base of a law of a foreign country:

- the effect of any provisions of foreign hybrid mismatch rules of a foreign country should be disregarded; and
- the effect of another law in a foreign country relating to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax) that has substantially the same effect as foreign hybrid mismatch rules should also be disregarded.

[Schedule 1, item 1, subsection 832-125(6)]

1.93 This will ensure that, where Australia has the right to neutralise a hybrid mismatch by denying a deduction, the fact that a foreign country may have sought to deny the hybrid mismatch by applying the OECD Action 2 Report secondary response rule to include an amount in assessable income is disregarded.

1.94 For the purposes of applying Division 832, it may be necessary to translate a foreign currency amount for an amount that is subject to foreign income tax into Australian currency.

1.95 In this regard, section 960-50 contains special translation rules that apply when an amount in a foreign currency is to be translated into Australian currency. Item 11A of the table in subsection 960-50(6) provides that, in circumstances where another item of the table does not apply to an amount, the amount is to be translated into Australian currency at the exchange rate that is reasonable in the circumstances (see Regulation 960-50.01 of the *Income Tax Regulations 1997*).

1.96 To avoid doubt, if a provision of Division 832 would require the amount that is subject to foreign income tax to be compared with another amount, it is reasonable for the purposes of item 11A of the table in subsection 960-50(6) (as modified by the regulations) to:

- if the other amount is also to be translated into Australian currency — apply the exchange rate applicable at the same time as both translations; or
- if the other amount is denominated in Australian currency — apply the exchange rate applicable at the time the other amount is recognised under the Australian income tax law.

[Schedule 1, item 1, subsection 832-125(7)]

Types of mismatches

- 1.97 A mismatch will be covered by the hybrid mismatch rules if it is:
- a hybrid financial instrument mismatch (Subdivision 832-C);
 - a hybrid payer mismatch (Subdivision 832-D);
 - a reverse hybrid mismatch (Subdivision 832-E);
 - a branch hybrid mismatch (Subdivision 832-F);
 - a deducting hybrid mismatch (Subdivision 832-G); or
 - an imported hybrid mismatch (Subdivision 832-H).

Neutralising hybrid mismatches

- 1.98 If a hybrid mismatch arises, the tax advantage obtained from the mismatch is neutralised by either:
- disallowing a deduction; or
 - including an amount in assessable income.

Dual inclusion income

1.99 The way that a hybrid mismatch is neutralised depends on the type of mismatch. However, where there is a neutralising amount for a hybrid payer mismatch or a deducting hybrid mismatch, the amount of the mismatch can be reduced by dual inclusion income.

1.100 An amount of income or profits is ***dual inclusion income*** if two or more of the following outcomes arise for the amount:

- it is subject to Australian income tax in an income year;
- it is subject to foreign income tax in a foreign country in a foreign tax period; or
- it is subject to foreign income tax in another foreign country in a foreign tax period.

[Schedule 1, items 1 and 8, subsection 832-740(1) and the definition of ‘dual inclusion income’ in subsection 995-1(1)]

Effect of Australian foreign income tax offset for underlying taxes

1.101 For the purposes of working out whether an amount of income or profits is dual inclusion income, a modification is made if:

- an amount of assessable income of an entity (the assessable amount) would, apart from subsection 832-740(2), be subject to Australian income tax; and

- an amount of foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax) paid in respect of the assessable amount counts towards a foreign income tax offset for an entity under Division 770.

[Schedule 1, item 1, paragraphs 832-740(2)(a) and (b)]

1.102 In these circumstances, for the purposes of applying subsection 832-740(1):

- if the amount of the tax offset equals or exceeds the amount of Australian tax that would be payable on the assessable amount (having regard only to the assessable amount and the rate at which tax is imposed on the entity) — the assessable amount is taken not to be subject to Australian income tax; and
- if the amount of the tax offset is a proportion of the amount of that tax — then that proportion of the assessable amount is taken not to be subject to Australian income tax.

[Schedule 1, item 1, paragraphs 832-740(2)(c) and (d)]

Example 1.3: Determining dual inclusion income for Australian company investing in a foreign partnership

ABC Ltd has assessable income of \$300, including \$140 that is derived through Foreign GP. The deductible interest expense incurred through Foreign GP is \$50, which is a deduction/deduction mismatch.

For Country B tax purposes, Foreign GP:

- includes the \$140 in working out its foreign income tax liability; and
- deducts the \$50 interest expense.

Country B's tax rate is 20 per cent. Therefore, Foreign GP is subject to \$18 tax in Country B.

The amount of dual inclusion income is \$80.

This is worked out by starting with the amount of income that is subject to Australian income tax and subject to foreign income tax of \$140.

However, this amount is reduced by the proportion of the assessable amount that reflects the tax offset available in respect of the Country B tax paid — worked out by dividing the foreign income tax paid by ABC Ltd's (as head company of the group) applicable tax rate (30 per cent). That is, \$18 (foreign income tax paid) / 30% (ABC Ltd's tax rate) = \$60.

Example 1.4: Determining dual inclusion income for disregarded Australian entity

Aus Co has assessable income of \$250 and a deductible payment to B Co of \$50. The deductible payment is a deduction/non-inclusion mismatch.

Aus Co also has a prior year loss of \$200 that it is able to utilise against its assessable income for the income year.

The amount of dual inclusion income for Aus Co for the income year is \$250.

This is worked out by starting with the amount of income that is subject to Australian tax and subject to foreign income tax (\$250). The utilisation of prior year losses does not affect this outcome.

The neutralising amount worked out for Aus Co under section 832-340 is therefore nil.

Effect of credits for underlying taxes

1.103 In addition, for the purposes of applying subsection 832-740(1), in determining whether an amount of income or profits is subject to foreign income tax in a foreign tax period, subsection 832-125(3) is disregarded. That subsection generally applies to modify the amount that is taken to be subject to foreign income tax where an amount is effectively sheltered from foreign income tax by a credit, rebate of other tax concession. [*Schedule 1, item 1, subsection 832-740(3)*]

Example 1.5: Determining dual inclusion income for company with an Australian taxable branch

ABC Co, a resident of Country B, derives assessable income through its Australian PE. ABC Co's assessable income is \$100 and is offset by interest expenses of \$20.

ABC Co's Australian tax liability is therefore \$24 (\$80 x 30 per cent).

For Country B's tax base purpose, ABC Co includes:

- the assessable income amount from Aus PE of \$100; and
- the deductible amount of interest of \$20.

The amount of dual inclusion income is \$100. This is the amount that is subject to Australian income tax and subject to foreign income tax, (disregarding subsection 832-125(3)).

Extension for certain on-payments through grouped entities

1.104 For the purposes of working out the amount of income or profits of an entity that is subject to Australian income tax or to foreign income tax in a foreign country in an inclusion period, the amount may be increased if:

- the entity is a member of a dual inclusion income group in a country — in this regard, two entities are members of a dual inclusion income group in a country if in that country:
 - the entity that is a liable entity in respect of the income or profits of each of the entities is the same entity; and
 - no other entity is a liable entity in respect of the income or profits of any of the entities.
- an amount of income or profits of the entity (the on-payment amount) is a payment received by the entity from another member of a dual inclusion income group at a time;
- it is reasonable to conclude that the payment was funded by an amount of income or profits of other member (the funding income or profits);
- the funding income or profits were:
 - if the country is Australia — subject to Australian income tax; or
 - if the country is a foreign country — subject to foreign income tax in the foreign country; and
- the funding income or profits were not dual inclusion income (disregarding subsection 832-740(5)) in the country.

[Schedule 1, item 1, subsections 832-740(4) and (6)]

1.105 In these circumstances, the on-payment amount is treated as if it were:

- if the country is Australia — subject to Australian income tax in the relevant income year; or
- if the country is a foreign country — subject to foreign income tax in the foreign country in the relevant foreign tax period.

[Schedule 1, item 1, subsection 832-740(5)]

When is an entity eligible to apply dual inclusion income?

1.106 An entity is eligible to apply an amount of dual inclusion income if the amount is income or profits of:

- the entity; or
- if the amount is not income or profits of the entity and the entity is a member of a dual inclusion income group in any country — an entity that is a member of the dual inclusion income group.

[Schedule 1, item 1, subsection 832-740(7)]

Hybrid financial instrument mismatch (Subdivision 832-C)

1.107 The hybrid financial instrument mismatch rules effectively implement Recommendation 1 of the OECD Action 2 Report.

What is a hybrid financial instrument mismatch?

1.108 A payment gives rise to a **hybrid financial instrument mismatch** if the payment gives rise to a hybrid mismatch under section 832-215 or 832-230 and either:

- the entity that made the payment and each entity that is a liable entity in respect of the income or profits of the recipient of the payment are related; or
- the scheme under which the payment is made is a structured arrangement.

[Schedule 1, items 1 and 8, subsections 832-200(1), (3) and (6), definition of ‘hybrid financial instrument mismatch’ in subsection 995-1(1)]

1.109 The deduction component of the hybrid financial instrument mismatch is the deduction component of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, subsection 832-200(2)]*

1.110 For the purposes of determining whether there is a hybrid financial instrument mismatch, two entities are related if:

- the entities are in the same Division 832 control group;
- one of the entities holds a *total participation interest* (as defined in section 960-180) of 25 per cent or more in the other entity; or
- a third entity holds a total participation interest of 25 per cent or more in each of the entities.

[Schedule 1, item 1, subsection 832-490(4)]

1.111 For these purposes, the *direct participation interest* (as defined in section 960-190) of an entity (the holding entity) in another entity (the test entity) is taken to be the sum of the direct participation interests held by the holding entity and its associates (as defined in section 318 of the ITAA 1936) in the test entity. *[Schedule 1, item 1, subsection 832-200(5)]*

What is a Division 832 control group?

1.112 Two or more entities are in the same **Division 832 control group** if:

- each of the entities is a member of a group of entities that are consolidated for accounting purposes as a single group;
- one of the entities holds a total participation interest of 50 per cent or more in each of the other entities; or

- a third entity holds a total participation interest of 50 per cent or more in each of the entities.

[Schedule 1, items 1 and 8, section 832-205 and the definition of 'Division 832 control group' in subsection 995-1(1)]

What is a structured arrangement?

1.113 A scheme under which a payment is made is a **structured arrangement** if the payment gives rise to a hybrid mismatch and either:

- the hybrid mismatch is priced into the terms of the scheme; or
- it is reasonable to conclude that the hybrid mismatch is a design feature of the scheme.

[Schedule 1, items 1 and 8, subsection 832-210(1) and the definition of 'structured arrangement' in subsection 995-1(1)]

1.114 The question whether a hybrid mismatch is a design feature of a scheme must be determined by reference to the facts and circumstances that exist in connection with the scheme, including the terms of the scheme. *[Schedule 1, item 1, subsection 832-210(2)]*

1.115 As noted in paragraph 326 of the OECD Action 2 Report, the fact that an arrangement produces a combination of tax and commercial benefits does not prevent the arrangement from being a structured arrangement.

1.116 An entity that entered into or carried out the scheme or any part of the scheme is a **party** to a structured arrangement unless:

- the entity could not reasonably have been expected to be aware that the scheme gave rise to a hybrid mismatch;
- no other entity in the same Division 832 control group as the entity could reasonably have been expected to be aware that the scheme gave rise to a hybrid mismatch; and
- the financial position of each entity in the Division 832 control group as the entity would reasonably be expected to have been the same if the scheme had not given rise to the hybrid mismatch.

[Schedule 1, items 1 and 2, subsection 832-210(3) and the definition of 'party' in subsection 995-1(1)]

1.117 As noted in paragraphs 318 to 320 of the OECD Action 2 Report, the structured arrangement definition is to be applied on an objective basis and is not intended to apply to a taxpayer who is unaware of the mismatch and derives no benefit from it. A party to a structured arrangement would be expected to have sufficient level of involvement in

the arrangement to understand the related tax effects. This should be determined from the information objectively available to the taxpayer.

1.118 The importance of these criteria is highlighted in paragraphs 344 to 346 of the OECD Action 2 report which demonstrate how the rule may apply to some widely held structures.

Interaction with other hybrid rules

1.119 If a hybrid financial instrument mismatch is an offshore hybrid mismatch, it might give rise to an imported hybrid mismatch.

1.120 A hybrid financial instrument mismatch is an offshore hybrid mismatch if:

- the deduction component of the mismatch is a foreign income tax deduction;
- no amount becomes subject to Australian income tax as a result of the application of the Australian secondary response in relation to the mismatch (section 832-185); and
- none of the following countries has foreign hybrid mismatch rules:
 - the country in which the foreign income tax deduction arose; and
 - any country in which income or profits of the recipient of the payment are subject to foreign income tax.

[Schedule 1, items 1 and 8, section 832-195 and the definition of ‘offshore hybrid mismatch’ in subsection 995-1(1)]

1.121 The amount of the offshore hybrid mismatch is the amount of the hybrid financial instrument mismatch. *[Schedule 1, item 1, subsection 832-195(2)]*

When does a payment give rise to a hybrid mismatch under section 832-215?

1.122 A payment gives rise to a ***hybrid mismatch*** under section 832-215 if:

- the payment is made under:
 - a *debt interest* (as defined in subsection 995-1(1));
 - an *equity interest* (as defined in subsection 995-1(1));
 - a *derivative financial arrangement* (as defined in subsection 995-1(1)); or
 - an arrangement covered by subsection 832-215(2) (about the transfer of financial instruments);

- the payment might reasonably be expected to give rise to a deduction/non-inclusion mismatch; and
- the mismatch that might reasonably be expected to arise, or a part of that mismatch, meets the hybrid requirement in section 832-220 or 832-225.

[Schedule 1, items 1 and 8, subsection 832-215(1) and the definition of 'hybrid mismatch' in subsection 995-1(1)]

1.123 An arrangement is covered by subsection 832-215(2) if:

- the arrangement is:
 - a reciprocal purchase agreement (or repurchase agreement);
 - a securities lending arrangement; or
 - a similar arrangement; and
- under the arrangement, the entity acquires a debt interest, an equity interest or a derivative financial arrangement.

[Schedule 1, item 1, subsection 832-215(2)]

1.124 The amount of the hybrid mismatch is generally the amount of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, paragraph 832-215(3)(a)]*

1.125 However, if only part of the deduction/non-inclusion mismatch meets the hybrid requirement, the amount of the hybrid mismatch is the amount of that part of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, paragraph 832-215(3)(b)]*

1.126 For the purposes of determining whether a payment might be reasonably expected to give rise to a deduction/non-inclusion mismatch, and the amount of the mismatch, regard should be had to:

- the terms of the debt interest, equity interest, derivative financial arrangement or other arrangement (as the case requires); and
- the characterisation of the payment.

1.127 These factors would typically include taking into account the tax residence and entity classification of the recipient. However, as noted in paragraphs 84 to 86 of the OECD Action 2 Report, it is not necessary that the entities know the precise treatment of the payment in the counterparty's taxable income calculation. A taxpayer will know its own tax position and should be able to determine a reasonable expectation of the likely tax outcome for the counterparty based on its knowledge of the counterparty's identity and the tax rules in the counterparty jurisdiction.

1.128 Where a payment is made through a transparent entity or is included in a tax base in more than one jurisdiction, it may be necessary to understand the tax laws of more than one jurisdiction to be able to determine whether an expected deduction/non-inclusion mismatch exists.

Example 1.6: Determining the expected tax outcome

Aus Co pays a dividend on a mandatorily redeemable preference share, to the holder of the preference shares, a foreign limited partnership.

The preference shares are debt interests for Australian tax purposes and the dividends are ordinarily deductible for Aus Co.

The partners in the foreign limited partnership are pension funds established in Country B.

The foreign limited partnership is tax transparent in both its country of formation and for the investor countries. Aus Co knows that Country B has a general exemption from income tax for pension funds.

Aus Co looks through the foreign limited partnership and might reasonably expect that, as the partners are exempt from tax (and because the limited partnership is a tax transparent entity), the dividend would not be subject to foreign income tax.

1.129 A deduction/non-inclusion mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-220 if:

- the payment that gives rise to the mismatch is made under a debt interest, an equity interest or a derivative financial arrangement;
- the mismatch, or the part of the mismatch, is attributable to differences in the treatment of the debt interest, equity interest or derivative financial arrangement arising from the terms of the interest or arrangement; and
- the exception in subsection 832-220(2) does not apply.

[Schedule 1, item 1, subsection 832-220(1)]

1.130 This test requires an assessment of whether, having regard to the terms of an instrument, jurisdictions would take a different view regarding the classification of the instrument (for example, as between debt and equity) which led to the mismatch arising. This could arise, for example, if in the case of dividends paid on a mandatorily redeemable preference share that is treated as a debt interest under the Australian income tax law if those dividends are not subject to foreign income tax on the basis that the laws of the foreign country have a participation exemption for dividends from legal form shares.

1.131 In addition, where the terms of an instrument enable an accrual deduction in one country but a cash basis inclusion in another (for example, where the terms allow for deferral of interest payments based on

certain contingencies), any resulting mismatch would also satisfy the requirements in section 832-220.

1.132 However, a hybrid mismatch that is attributable to the tax exempt status of the taxpayer or solely attributable to the context in which the interest is held will not be a mismatch to which the rules apply.

Example 1.7: Determining if the expected tax outcome is attributable to the terms of the instrument

Aus Co, from Example 1.6, now determines whether the deduction/non-inclusion mismatch it identified in respect of the dividend payments meets the hybrid requirement in section 832-220.

Because the recipients are pension funds that are not taxed on any income, it is reasonable to conclude that the expected deduction/non-inclusion mismatch is attributable to the tax exempt status of the entities, rather than to differences in the treatment of the financing arrangement.

Consequently, the hybrid requirement would not be met and the payment would not give rise to hybrid financial instrument mismatch.

Example 1.8: Determining if the expected tax outcome is attributable to the terms of the instrument

Aus Co, an Australian resident company is a wholly owned subsidiary of Foreign Parent Co, a company resident in Country B.

Aus Co declares and pays an unfranked dividend on its ordinary shares (equity interest) to Foreign Parent Co of 100. AusCo is entitled, under section 46FA of the ITAA 1936 to a deduction for the amount of on-paid dividend. The dividend is not subject to foreign income tax because Foreign Parent Co is eligible to claim the participation exemption in Country B for the amount of the dividend.

The deduction/non-inclusion mismatch in this case would not be attributable to differences in the treatment of the debt interest, equity interest or derivative financial arrangement arising from the terms of the interest or arrangement. This is because both countries view the distribution as being on equity, even though Australia provides a deduction in respect of the distribution.

1.133 The exception in subsection 832-220(2) applies (so that the mismatch will not meet the hybrid requirement in section 832-220) if both of the following conditions are met:

- the difference in treatment of the debt interest, equity interest or derivative financial arrangement primarily relates to a deferral in the recognition of income or profits under the debt interest, equity interest or derivative financial arrangement; and

- the term of the instrument or arrangement is three years or less.

[Schedule 1, item 1, paragraph 832-220(1)(c) and subsection 832-220(2)]

1.134 A deduction/non-inclusion mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-225 if:

- the payment that gives rise to the mismatch is made under an arrangement covered by subsection 832-215(2); and
- the mismatch, or the part of the mismatch, is attributable to differences in the treatment of the arrangement.

[Schedule 1, item 1, subsection 832-225(1)]

1.135 However, the mismatch will not meet the hybrid requirement in section 832-225 if:

- the difference in treatment of the arrangement primarily relates to a deferral in the recognition of income or profits under the arrangement; and
- the term of the instrument or arrangement is three years or less.

[Schedule 1, item 1, paragraph 832-225(1)(c) and subsection 832-225(2)]

1.136 The exclusions in subsections 832-220(2) and 832-225(2) reflect the recommendation made by the Board of Taxation to exclude financial instruments or arrangements with a term of three years or less from the scope of the OECD hybrid financial instrument rule where the mismatch is merely one of timing.

When does a payment give rise to a hybrid mismatch under section 832-230?

1.137 A payment gives rise to a ***hybrid mismatch*** under section 832-230 if:

- the payment gives rise to a deduction/non-inclusion mismatch;
- the payment is made under an arrangement that involves the transfer of a debt interest, an equity interest or a derivative financial arrangement;
- the payment, or part of the payment, (the substitute payment) could reasonably be regarded as having been converted into a form that is in substitution for a return (however described) on the interest or arrangement; and
- the return is covered by subsection 832-230(2).

[Schedule 1, item 1, subsection 832-230(1)]

1.138 A return is covered by subsection 832-230(2) if it is a return (however described) on a debt interest, an equity interest or a derivative financial arrangement that is transferred and:

- the return is made to the payer of the substitute payment and is not subject to foreign income tax or subject to Australian income tax;
- the return is not made to the payer of the substitute payment, but if it had been it would not have been subject to foreign income tax or subject to Australian income tax; or
- if the return were instead made to the payee of the substitute payment:
 - it would be subject to foreign income tax or subject to Australian income tax; or
 - it would give rise to a hybrid mismatch under section 832-215.

[Schedule 1, item 1, subsection 832-230(2)]

1.139 The amount of the hybrid mismatch is the amount of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, subsection 832-230(3)]*

Extended operation of the hybrid financial instrument mismatch rule

1.140 The operation of the hybrid financial instrument mismatch rule is extended so that it also applies if an amount of income or profits was subject to foreign income tax in circumstances where the rate of tax was lower than the ordinary rate of tax that applies to interest income in that jurisdiction. As noted in paragraph 43 of the OECD Action 2 Report, for reduced rate mismatches, the amount denied should be no more than is necessary to eliminate the mismatch.

1.141 In this regard, an amount of income or profits is taken not to be subject to foreign income tax if:

- apart from section 832-235, the amount would be subject to foreign income tax; and
- the rate of foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) (the lower rate) on the amount under the law of the relevant foreign country is lower than the rate (the ordinary rate) that would ordinarily be imposed on interest income derived by an entity of that kind in the foreign country.

[Schedule 1, item 1, subsections 832-235(1) and (2)]

1.142 However, for the purpose of working out the amount of the deduction/non-inclusion mismatch that would be affected by

section 832-235, the amount of a payment that is treated as being subject to foreign tax is to be discounted by multiplying it by the fraction:

$$\frac{\text{Lower rate}}{\text{Ordinary rate}}$$

[Schedule 1, item 1, subsection 832-235(3)]

Consequences that arise if a payment gives rise to a hybrid financial instrument mismatch

1.143 The hybrid financial instrument mismatch rules apply to neutralise a hybrid financial instrument mismatch of an entity if:

- apart from section 832-180, the entity would be entitled to an Australian income tax deduction in an income year in respect of the payment; and
- the deduction is the deduction component of a hybrid financial instrument mismatch to which the payment gives rise.

[Schedule 1, item 1, subsection 832-180(1)]

1.144 In these circumstances, the mismatch is neutralised by applying the Australian primary response to disallow the deduction to the extent that it does not exceed the amount of the hybrid financial instrument mismatch. *[Schedule 1, item 1, subsection 832-180(2)]*

1.145 The hybrid financial instrument mismatch rules also apply to neutralise a hybrid financial instrument mismatch of an entity if:

- the entity is the recipient of a payment that gives rise to a hybrid financial instrument mismatch;
- the deduction component of the hybrid financial instrument mismatch is a foreign income tax deduction; and
- the Australian secondary response is required.

[Schedule 1, item 1, subsection 832-185(1)]

1.146 For these purposes, the Australian secondary response is required unless the foreign income tax deduction is in a foreign country that has foreign hybrid mismatch rules or another law that has substantially the same effect as foreign hybrid mismatch rules. *[Schedule 1, item 1, subsection 832-185(2)]*

1.147 If the Australian secondary response applies, an amount equal to the amount of the hybrid financial instrument mismatch is included in the entity's assessable income for the income year that is:

- if the foreign tax period in which the foreign income tax deduction arises wholly within an income year of the entity — that income year; or

- if the foreign tax period in which the foreign income tax deduction arises straddles two income years of the entity — the earlier of those income years.

[Schedule 1, item 1, subsections 832-185(3) and (4)]

1.148 The assessable income is taken to have been derived from the same source as the payment. *[Schedule 1, item 1, subsection 832-185(3)]*

1.149 However, a hybrid financial instrument mismatch of an entity in respect of a payment is not neutralised under section 832-180 or 832-185 if:

- the scheme under which the payment is made is a structured arrangement to which the entity is not a party; and
- the entity that made the payment and each entity that is a liable entity in respect of the income or profits of the recipient of the payment are not related.

[Schedule 1, item 1, section 832-190]

Adjustment if a hybrid financial instrument payment is income in a later income year

1.150 If an amount that gave rise to a hybrid mismatch is a hybrid financial instrument payment that is appropriately recognised in a later income year, an adjustment is made in that later income year to allow the deduction.

1.151 The adjustment applies for an income year (the adjustment year) if:

- an amount was disallowed or disregarded for the entity in an earlier income year under subsection 832-180(2) in respect of a payment that gave rise to a hybrid financial instrument mismatch; and
- an amount (the taxed amount) of the payment is:
 - subject to foreign income tax in a foreign country in a foreign tax period that ends within 12 months after the end of the adjustment year; or
 - subject to Australian income tax in a relevant income year.

[Schedule 1, item 1, subsections 832-240(1)]

1.152 However, no adjustment is available if the hybrid mismatch arises because of section 832-235. *[Schedule 1, item 1, subsection 832-240(4)]*

1.153 In these circumstances, the entity can deduct the taxed amount in the adjustment year. *[Schedule 1, item 1, subsection 832-240(2)]*

1.154 However, the total amounts deducted must not exceed the amount disallowed, or disregarded, in respect of the payment. [*Schedule 1, item 1, subsection 832-240(3)*]

Example 1.9: Determining the adjustment year

Aus Sub has a tax year end of 30 June.

Aus Sub has on issue a five year a zero coupon bond, with a maturity date of 30 June 2020 to a related person (who is resident in Country B). The related person has a tax year end of 31 March for Country B tax purposes.

Aus Sub would ordinarily be entitled to a deduction for the original issue discount (interest) on an accrual basis. Country B taxes the redemption premium at the time of redemption, rather than on an accrual basis (that is, in the tax year ended 31 March 2021).

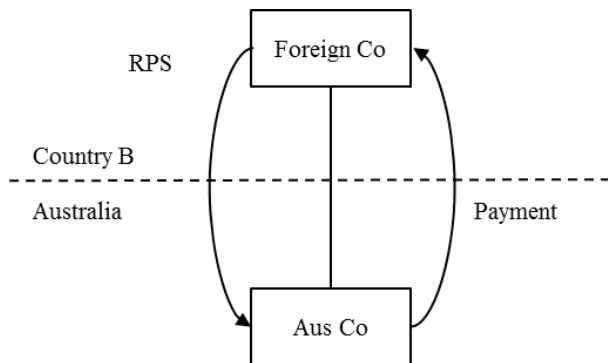
For the year ending 30 June 2018, a deduction/non-inclusion outcome arises for Aus Sub. Consequently, Aus Sub was denied a deduction for the accrued interest in the tax year ending 30 June 2018.

However, because the payment is subject to foreign tax in the foreign tax period ending 31 March 2021, the tax year ending 30 June 2020 is an adjustment year.

Therefore, Aus Sub can deduct the amount in the tax year ending 30 June 2020.

Examples of the operation of the hybrid financial instrument mismatch rules

Example 1.10: Payment gives rise to a hybrid financial instrument mismatch



Aus Co issues 9 year redeemable preference shares to Foreign Co, which owns 100 per cent of the voting interests in Aus Co.

Under the terms of the redeemable preference shares, a return (that is, a dividend) accrues daily and, to the extent accrued dividends are unpaid, forms part of the redemption price.

In Australia, the redeemable preference shares are debt interests for income tax purposes and the returns are ordinarily deductible as they accrue.

Country B has a participation exemption for resident companies that receive dividends on shares in a foreign subsidiary, provided the shareholder owns at least 10 per cent of the voting rights in the foreign subsidiary.

Therefore, Aus Co expects that there is a deduction/non-inclusion mismatch and the mismatch is attributable to the terms of the debt interest

Consequently, section 832-180 applies to disallow the deduction that Aus Co could otherwise claim for the returns as they accrue.

Example 1.11: Payment gives rise to a hybrid financial instrument mismatch – timing

Assume the facts are the same as in Example 1.10, except that Country B does not have a participation exemption for dividends. As a result, the dividends would be taxable in Country B when paid to Foreign Co.

Although Aus Co expects that the dividends would be subject to foreign tax upon redemption, there would be a deduction/non-inclusion mismatch if the redemption date is later than 12 months after the end of the income year in which the deduction arises for Aus Co.

The exception to the hybrid financial instruments rule in subsection 832-220(2) does not apply as the redeemable preference shares have a term of greater than three years.

Therefore, Aus Co's deductions are deferred until the payment of the dividends (section 832-240).

Hybrid payer mismatch (Subdivision 832-D)

1.155 The hybrid payer mismatch rules effectively implement Recommendation 3 of the OECD Action 2 Report.

What is a hybrid payer mismatch?

1.156 A payment gives rise to a **hybrid payer mismatch** if the payment gives rise to a hybrid mismatch under section 832-320 and either:

- the entity that is the hybrid payer and each entity that is a liable entity in respect of the income or profits of the hybrid payer are in the same Division 832 control group; or
- the scheme under which the payment is made is a structured arrangement.

[Schedule 1, items 1 and 8, section 832-315 and the definition of 'hybrid payer mismatch' in subsection 995-1(1)]

1.157 The deduction component of the hybrid payer mismatch is the deduction component of the deduction/non-inclusion mismatch mentioned in subsection 832-320. *[Schedule 1, item 1, subsection 832-315(2)]*

Interaction with other hybrid mismatch rules

1.158 A payment does not give rise to a hybrid payer mismatch if it gave rise to a hybrid financial instrument mismatch. *[Schedule 1, item 1, section 832-315(3)]*

1.159 However, if a hybrid payer mismatch is an offshore hybrid mismatch, it might give rise to an imported hybrid mismatch.

1.160 A hybrid payer mismatch is an offshore hybrid mismatch if:

- the deduction component of the mismatch is a foreign income tax deduction;
- no amount becomes subject to Australian income tax as a result of the application of the Australian secondary response in relation to the mismatch (section 832-300); and
- none of the following countries has foreign hybrid mismatch rules:
 - the country in which the foreign income tax deduction arose; and
 - any country in which income or profits of the recipient of the payment are subject to foreign income tax.

[Schedule 1, items 1 and 8, subsection 832-310(1) and the definition of ‘offshore hybrid mismatch’ in subsection 995-1(1)]

1.161 The amount of the offshore hybrid mismatch is the neutralising amount for the hybrid payer mismatch. *[Schedule 1, item 1, subsection 832-310(2)]*

When does a payment give rise to a hybrid mismatch under section 832-320?

1.162 A payment gives rise to a ***hybrid mismatch*** under section 832-320 if:

- the payment gives rise to a deduction/non-inclusion mismatch; and
- the payment meets the hybrid requirement in section 832-325.

[Schedule 1, items 1 and 8, subsection 832-320(1) and definition of ‘hybrid mismatch’ in subsection 995-1(1)]

1.163 The amount of the hybrid mismatch is the lesser of:

- the amount of the deduction/non-inclusion mismatch; and

- the amount of the excess from subsection 832-325(2) or (3) (whichever is applicable).

[Schedule 1, item 1, subsection 832-320(2)]

1.164 A payment meets the hybrid requirement in section 832-325 if the payment is made by a hybrid payer and:

- the non-including country identified in subsection 832-330(3) is Australia; and
- the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to Australian income tax for an income year was instead worked out on the assumption that the payment had instead been made to the same recipient, but by an entity that was a liable entity in the non-including country only in respect of its own income or profits.

[Schedule 1, item 1, subsections 832-325(1), (2) and (4)]

1.165 A payment also meets the hybrid requirement in section 832-325 if the payment is made by a hybrid payer and:

- the non-including country identified in subsection 832-330(3) is a foreign country; and
- the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to foreign income tax for a foreign tax period was instead worked out on the assumption that the payment had instead been made to the same recipient, but by an entity that was a liable entity in the non-including country only in respect of its own income or profits.

[Schedule 1, item 1, subsections 832-325(1), (3) and (4)]

When is an entity a hybrid payer?

1.166 An entity (the test entity) is a hybrid payer in relation to a payment it makes if:

- subsection 832-330(2) applies to the entity in relation to the country and the payment; and
- subsection 832-330(3) applies to the entity in relation to a different country and the payment.

[Schedule 1, items 1 and 8, subsection 832-330(1) and the definition of 'hybrid payer' in subsection 995-1(1)]

1.167 Subsection 832-330(2) applies to a test entity in relation to the country (the deducting country) and the payment the test entity makes if:

- the test entity, or another entity, is a liable entity in the deducting country in respect of the income or profits of the test entity (or a part of those income or profits); and
- that liable entity is not also a liable entity in the deducting country in respect of the income or profits of the recipient of the payment.

[Schedule 1, item 1, subsection 832-330(2)]

1.168 Subsection 832-330(3) applies to a test entity in relation to the country (a non-including country) and the payment the test entity makes if:

- the test entity, or another entity, is a liable entity in the non-including country in respect of the income or profits of the test entity (or a part of those income or profits); and
- that liable entity is not also a liable entity in the non-including country in respect of the income or profits of the recipient of the payment.

[Schedule 1, item 1, subsection 832-330(3)]

When is an entity a liable entity?

1.169 An entity is a ***liable entity***, in a country, in respect of its income or profits if:

- for Australia — tax is imposed on the entity in respect of all or part of the income or profits of the test entity for an income year; and
- for a foreign country — foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) is imposed under the law of a foreign country on the entity in respect of all or part of the income or profits of the test entity for a foreign tax period.

[Schedule 1, items 1 and 8, subsection 832-335(1) and the definition of ‘liable entity’ in subsection 995-1(1)]

1.170 An entity is a ***liable entity***, in a country, in respect of the income or profits of another entity (the test entity) if:

- for Australia — tax is imposed on the entity in respect of all or part of the income or profits of the test entity for an income year; and
- for a foreign country — foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) is

imposed under the law of a foreign country on the entity in respect of all or part of the income or profits of the test entity for a foreign tax period.

[Schedule 1, items 1 and 8, subsection 832-335(2) and the definition of 'liable entity' in subsection 995-1(1)]

1.171 Generally, an entity that is liable to pay income tax (that is, a non-transparent entity such as a company) in Australia or a foreign country is a liable entity in the jurisdiction(s) in which it is a taxpayer. However, a transparent entity (such as a trust or partnership where the beneficiaries or partners pay tax on the profits of the trust or partnership) would generally not be a liable entity in respect of its own profits or the profits of another entity.

1.172 However, in some circumstances a company may not be liable entity. This would be the case, for example, for an entity that is disregarded for tax purposes or for a subsidiary member of a tax consolidated group.

1.173 Similarly, there may be circumstances when a trust or partnership would be a liable entity — for example, in Australia where a trustee is assessed and liable to pay income tax under the section 102S of the ITAA 1936.

1.174 To avoid doubt, the following outcomes may arise under subsection 832-335(2) in a country:

- there may be one or more liable entities in respect of the income or profits of a test entity; and
- there may be one or more interposed entities between the test entity and an entity that is a liable entity in respect of the income or profits of the test entity.

[Schedule 1, item 1, subsection 832-335(3)]

1.175 Further, to avoid doubt, an entity may be a liable entity in respect of its own, or another entity's, income of profits in a country even if any of the following situations exist:

- there are no actual income of profits;
- there are income of profits, but no part of those income of profits is:
 - for Australia — subject to Australian income tax; or
 - for a foreign country — subject to foreign income tax in that foreign country; or
- the entity is not actually liable to pay an amount of Australian tax or foreign income tax.

[Schedule 1, item 1, subsection 832-335(4)]

1.176 In this regard, in determining whether an entity is a liable entity in such a situation, it must be assumed that income or profits within the tax base of the country exist. [*Schedule 1, item 1, subsection 832-335(4)*]

1.177 Therefore, for the purposes of determining whether an entity is a liable entity in a particular country in respect of its own or another entity's income or profits, it is necessary to consider who would pay tax on that income or profits, rather than on the actual circumstances of a particular entity in a particular income year.

1.178 Consequently, if, for example, a test entity is an entity of a type that is normally subject to tax but has a tax loss for a particular income year (and therefore has no tax liability in that particular income year), the test entity will still be a liable entity.

1.179 An entity is not a liable entity in respect of the income or profits of another entity (the test entity) merely because all or part of the income or profits of the test entity are:

- included under the controlled foreign company provisions (section 456 or 457 of the ITAA 1936) in the assessable income of the other entity; or
- included under a corresponding provision of a law of a foreign country in working out the tax base of that other entity (including a tax base of nil or a negative amount).

[*Schedule 1, item 1, subsection 832-335(5)*]

Consequences that arise if a payment gives rise to a hybrid payer mismatch

1.180 The hybrid payer mismatch rules apply to neutralise a hybrid payer mismatch of an entity if:

- apart from section 832-295, the entity would be entitled to an Australian income tax deduction in an income year in respect of the payment; and
- the deduction is the deduction component of a hybrid payer mismatch to which the payment gives rise.

[*Schedule 1, item 1, subsection 832-295(1)*]

1.181 In these circumstances, the mismatch is neutralised by applying the Australian primary response to disallow the deduction to the extent that it does not exceed the amount of the hybrid payer mismatch.

[*Schedule 1, item 1, subsection 832-295(2)*]

1.182 The hybrid payer mismatch rules also apply to neutralise a hybrid payer mismatch of an entity if:

- the entity is the recipient of a payment that gives rise to a hybrid payer mismatch;

- the deduction component of the hybrid payer mismatch is a foreign income tax deduction; and
- the Australian secondary response is required.

[Schedule 1, item 1, subsection 832-300(1)]

1.183 For these purposes, the Australian secondary response is required unless the foreign income tax deduction is in a foreign country that has foreign hybrid mismatch rules or another law that has substantially the same effect as Australia's foreign hybrid mismatch rules.

[Schedule 1, item 1, subsection 832-300(2)]

1.184 If the Australian secondary response applies, an amount equal to the neutralising amount for the hybrid payer mismatch is included in the entity's assessable income for the inclusion year. The assessable income is taken to have been derived from the same source as the payment.

[Schedule 1, item 1, subsection 832-300(3)]

1.185 The inclusion year is:

- if the foreign tax period in which the foreign income tax deduction mentioned arises wholly within an income year of the entity — that income year; or
- if the foreign tax period in which the foreign income tax deduction arises straddles two income years of the entity — the earlier of those income years.

[Schedule 1, item 1, subsection 832-300(4)]

1.186 However, a hybrid payer mismatch of an entity in respect of a payment is not neutralised under section 832-295 or 832-300 if:

- the scheme under which the payment is made is a structured arrangement to which the entity is not a party; and
- the entity that made the payment and each entity that is a liable entity in respect of the income or profits of the recipient of the payment are not related.

[Schedule 1, item 1, section 832-305]

What is the neutralising amount?

1.187 The neutralising amount for a hybrid payer mismatch is the amount of the hybrid mismatch reduced (but not below nil) by the amount of dual inclusion income that is available to be applied by the entity in working out the neutralising amount. *[Schedule 1, item 1, subsection 832-340(1)]*

1.188 An amount of dual inclusion income is available to be applied to reduce the neutralising amount for a hybrid payer mismatch to which section 832-340 applies if:

- the hybrid payer is eligible to apply the amount (under subsection 832-740(7));
- the amount is subject to Australian income tax for the purposes of subsection 832-740(1) in the income year mentioned in subsection 832-295(1); and
- the amount is subject to foreign income tax for the purposes of subsection 832-740(1) in the non-including country identified in subsection 832-330(3).

[Schedule 1, item 1, subsection 832-340(2)]

1.189 An amount of dual inclusion income is available to be applied to reduce the neutralising amount for a hybrid payer mismatch to which section 832-300 applies if:

- the recipient of the payment is eligible to apply the amount (under subsection 832-740(7));
- the amount is subject to Australian income tax for the purposes of subsection 832-740(1) in the inclusion year mentioned in subsection 832-300(4); and
- in the same foreign tax period as the period in which the foreign income tax deduction arose, the amount is subject to foreign income tax for the purposes of subsection 832-740(1) in the deducting country mentioned in subsection 832-330(2).

[Schedule 1, item 1, subsection 832-340(3)]

1.190 An amount of dual inclusion income is available to be applied to reduce the neutralising amount for a hybrid payer mismatch that is an offshore hybrid mismatch if:

- the hybrid payer is eligible to apply the amount (under subsection 832-740(7));
- in the same foreign tax period as the period in which the foreign income tax deduction arose, the amount is subject to foreign income tax for the purposes of subsection 832-740(1) in the deducting country mentioned in subsection 832-330(2); and
- the amount is subject to foreign income tax for the purposes of subsection 832-740(1) in the non-including country identified in subsection 832-330(3).

[Schedule 1, item 1, subsection 832-340(4)]

Adjustment if hybrid payer derives dual inclusion income in a later year

1.191 If a hybrid payer derives dual inclusion income in a later year, an adjustment is made in that later income year to offset the neutralising amount.

1.192 The adjustment applies for an entity for an income year (the adjustment year) if:

- in an earlier income year, all or part of a deduction of the entity in respect of a payment that gave rise to a hybrid payer mismatch was not allowable under section 832-295;
- an amount of dual inclusion income is:
 - available to be applied by the hybrid payer in the adjustment year;
 - subject to Australian income tax for the purposes of subsection 832-740(1) in the adjustment year; and
 - subject to foreign income tax for the purposes of subsection 832-740(1) in the non-including country identified in subsection 832-330(3).

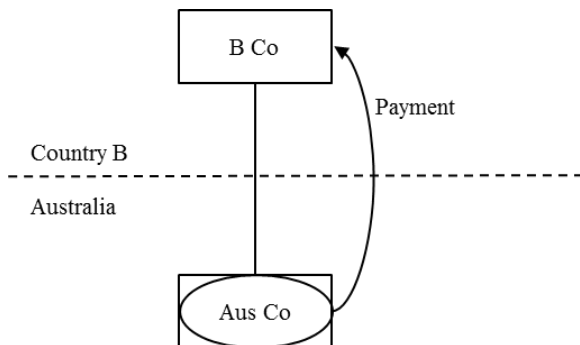
[Schedule 1, item 1, subsection 832-345(1)]

1.193 In these circumstances, so much of the dual inclusion income that satisfies the requirements in paragraph 832-345(1)(b) as does not exceed the amount that was disallowed as a deduction can be deducted by the entity in the adjustment year. *[Schedule 1, item 1, subsection 832-345(2)]*

1.194 However, for the purposes of a later application of section 832-345, the amount that was disallowed as a deduction under section 832-295 is taken to be reduced by the amount deducted under subsection 832-345(2). *[Schedule 1, item 1, subsection 832-345(3)]*

Examples of the operation of the hybrid payer mismatch rules

Example 1.12: Payment gives rise to a hybrid payer mismatch — Australian primary response



Aus Co makes a deductible payment to its parent (B Co) for the provision of services.

For Australian tax purposes, Aus Co (the test entity) is a liable entity in respect of its own profits, as it is as an Australian resident company.

Aus Co is a hybrid payer because:

- in the deducting country (Australia), Aus Co is a liable entity in respect of its own profits and is not also a liable entity in Australia in respect of the profits of B Co; and
- in the non-including country (Country B), B Co is a liable entity in respect of the income or profits of Aus Co and B Co (the recipient of the payment).

Example 1.13: Mismatch attributable to payment made by hybrid payer

Aus Co makes a deductible payment to B Sub. B Sub is a company formed in Country C and is also a wholly owned subsidiary of B Co. Country C does not impose income tax. B Sub is not a tax resident of any other country.

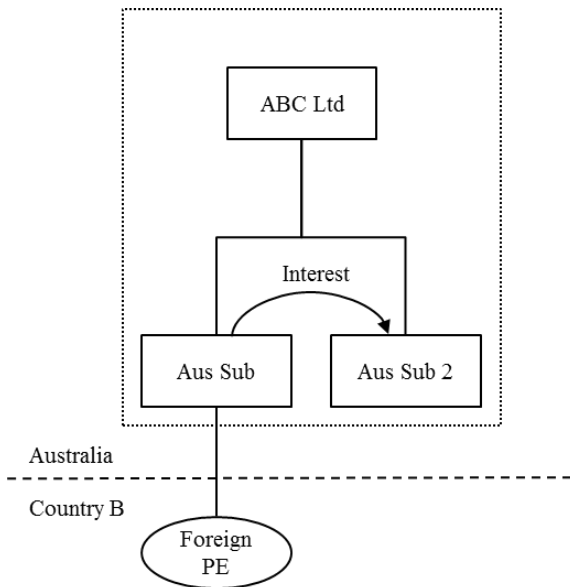
Country B treats B Sub as a disregarded entity and profits of B Sub are treated as being derived directly by B Co.

The payment from Aus Co to B Sub is not subject to foreign income tax because:

- Country C does not impose income tax; and
- Country B consider Aus Co and B Sub to be disregarded entities,.

The hybrid requirement is met because, if it is assumed that Aus Co was a liable entity in respect of its own income or profits for the purposes of Country B's tax laws (that is, not grouped for tax purposes with B Co), the payment from Aus Sub to B Sub would have been subject to foreign income tax in Country B.

Example 1.14: Payment gives rise to a hybrid payer mismatch – Australian secondary response



Aus Sub and Aus Sub 2 are members of the ABC Ltd consolidated group. Aus Sub:

- has borrowed money from Aus Sub 2 to fund its offshore permanent establishment in Country B; and
- pays interest on the borrowing to Aus Sub 2.

ABC Ltd is a liable entity in Australia in respect of the income or profits of both Aus Sub and Aus Sub 2. Therefore, the requirement in subsection 832-330(3) is met.

In Country B, Aus Sub is the liable entity in respect of its own income or profits.

Consequently, the interest payment by Aus Co is deductible in Country B against the profits of Aus Sub’s Country B PE, but is not subject to Australian income tax because of the single entity rule.

Accordingly, Aus Sub is a hybrid payer and the interest payment gives rise to a deduction/non-inclusion mismatch.

Country B has not implemented foreign hybrid mismatch rules and does not have another law that has substantially the same effect as foreign hybrid mismatch rules.

As Aus Sub 2 is the recipient and because the secondary response is required, ABC Ltd (as the head company of the Australian tax consolidated group) includes the amount of the deduction/non-inclusion mismatch in its assessable income

Example 1.15: Payment gives rise to a hybrid payer mismatch – inbound secondary response

ABC Pty Ltd is the head company of the ABC multiple entry consolidated group (ABC MEC Group).

Aus LP is an Australian limited partnership and eligible tier-1 company of the ABC MEC Group.

Country B treats Aus LP as a partnership. The partners are liable entities in respect of Aus LP's profits in Country B.

Aus LP makes a payment to ABC Pty Ltd that is ignored for Australian tax purposes under the single entity rule. However, the payment is taken into account as a deductible payment for the partners in Country B.

Therefore, the payment gives rise to a deduction/non-inclusion mismatch for Aus LP equal to the amount of the payment.

Country B has not implemented foreign hybrid mismatch rules and does not have another law that has substantially the same effect as foreign hybrid mismatch rules.

Consequently, the recipient of the payment ABC Pty Ltd (who is also the head company of the ABC MEC Group), would need to include an amount in assessable income.

However, the amount included in assessable income would be reduced to the extent that Aus LP has dual inclusion income.

Reverse hybrid mismatch (Subdivision 832-E)

1.195 The reverse hybrid mismatch rules effectively implement Recommendation 4 of the OECD Action 2 Report.

What is a reverse hybrid mismatch?

1.196 A payment gives rise to a **reverse hybrid mismatch** if the payment gives rise to a hybrid mismatch under section 832-420 and either:

- the following entities are in the same Division 832 control group:
 - the entity that made the payment;
 - the entity that is the reverse hybrid; and
 - each entity that is an investor identified in paragraph 832-430(2)(c) in relation to the reverse hybrid;
 or
- the scheme under which the payment is made is a structured arrangement.

[Schedule 1, items 1 and 8, subsections 832-415(1), (3) and (4) and the definition of 'reverse hybrid mismatch' in subsection 995-1(1)]

1.197 The deduction component of the reverse hybrid mismatch is the deduction component of the deduction/non-inclusion mismatch mentioned in subsection 832-420. *[Schedule 1, item 1, subsection 832-415(2)]*

Interaction with other hybrid mismatch rules

1.198 A payment does not give rise to a reverse hybrid mismatch if it gave rise to a hybrid financial instruments mismatch or a hybrid payer mismatch. *[Schedule 1, item 1, section 832-415(5)]*

1.199 However, if a reverse hybrid mismatch is an offshore hybrid mismatch, it might give rise to an imported hybrid mismatch.

1.200 A reverse hybrid mismatch is an offshore hybrid mismatch if:

- no deduction arises in respect of the mismatch; and
- the country in which the foreign income tax deduction arose does not have foreign hybrid mismatch rules.

[Schedule 1, items 1 and 8, section 832-410 and the definition of 'offshore hybrid mismatch' in subsection 995-1(1)]

1.201 The amount of the offshore hybrid mismatch is the neutralising amount for the reverse hybrid mismatch. *[Schedule 1, item 1, subsection 832-410(2)]*

When does a payment give rise to a hybrid mismatch under section 832-420?

1.202 A payment gives rise to a ***hybrid mismatch*** under section 832-420 if:

- the payment gives rise to a deduction/non-inclusion mismatch; and
- the payment meets the hybrid requirement in section 832-425.

[Schedule 1, items 1 and 8, subsection 832-420(1) and definition of 'hybrid mismatch' in subsection 995-1(1)]

1.203 The amount of the hybrid mismatch is the lesser of:

- the amount of the deduction/non-inclusion mismatch; and
- if there is an excess under subparagraph 832-425(2)(b)(i) or (3)(b)(i) — the amount of the excess.

[Schedule 1, item 1, subsection 832-420(2)]

1.204 A payment meets the hybrid requirement in section 832-425 if the payment is made directly, or indirectly through one or more interposed entities, to a reverse hybrid and:

- the investor country identified in subsection 832-430(3) is Australia; and
- either:
 - the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to Australian income tax for an income year was instead worked out on the assumption that the payment had instead been made to the same entity but directly to the investing taxpayer identified in paragraph 832-430(3)(a) or (b); or
 - on the same assumption, the payment would have given rise to a hybrid mismatch under section 832-215 (about hybrid financial instruments), section 832-320 (about hybrid payers) or section 832-420 (about reverse hybrids).

[Schedule 1, item 1, subsections 832-425(1), (2) and (4)]

1.205 A payment also meets the hybrid requirement in section 832-425 if the payment is made directly, or indirectly through one or more interposed entities, to a reverse hybrid and:

- the investor country identified in subsection 832-430(3) is a foreign country; and
- on the assumption that the payment had instead been made to the same entity but directly to the investing taxpayer identified in paragraph 832-430(3)(a) or (b), either:
 - the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to foreign income tax for a foreign tax period was instead worked out on the assumption that the payment had instead been made to the same entity but directly to the investing taxpayer identified in paragraph 832-430(3)(a) or (b); or
 - on the same assumption, the payment would have given rise to a hybrid mismatch under section 832-215 (about hybrid financial instruments), section 832-320 (about hybrid payers) or section 832-420 (about reverse hybrids).

[Schedule 1, item 1, subsections 832-425(1), (3) and (4)]

When is an entity a reverse hybrid payer?

1.206 An entity (the test entity) is a reverse hybrid in relation to a payment made to it if:

- subsection 832-430(2) applies to the entity in relation to a country and the payment; and
- subsection 832-430(3) applies to the entity in relation to a different country and the payment.

[Schedule 1, items 1 and 8, subsection 832-430(1) and the definition of ‘reverse hybrid’ in subsection 995-1(1)]

1.207 Subsection 832-430(2) applies to a test entity in relation to a country (the formation country) and a payment made to the entity if:

- the test entity is formed in the formation country; and
- for the formation country, the test entity is:
 - not a liable entity; and
 - for Australia — not a member of a consolidated group;
- for the formation country, another entity (an investor) is a liable entity in respect of the income or profits of the test entity.

[Schedule 1, item 1, subsection 832-430(2)]

1.208 Subsection 832-430(3) applies to a test entity in relation to a country (the investor country) and a payment made to the entity if, in the investor country:

- an investor identified in paragraph 832-430(2)(c) is a liable entity (an investing taxpayer) in respect of its own income or profits, but not in respect of the test entity’s income or profits; or
- an entity that is a liable entity (also an investing taxpayer) in respect of the investor’s is not also a liable entity in respect of the test entity’s income or profits.

[Schedule 1, item 1, subsection 832-430(3)]

1.209 Where there are multiple investors in a reverse hybrid, the deduction/non-inclusion mismatch is limited to the extent to which the payment is allocated to an investor which satisfies the reverse hybrid test in subsection 832-430.

1.210 However, as noted in paragraph 146 of the OECD Action 2 Report, subsequent payments by a reverse hybrid, including distributions of funds derived from the payments received, will not be taken into account in determining whether a deduction/non-inclusion mismatch arises.

Consequences that arise if a payment gives rise to a reverse hybrid mismatch

1.211 If a payment gives rise to a reverse hybrid mismatch and, apart from section 832-400, an entity would be entitled to an Australian income tax deduction in an income year (the deduction year) in respect of the payment, then the mismatch is neutralised by applying the Australian primary response to disallow the deduction to the extent that it does not exceed the amount of the reverse hybrid mismatch. *[Schedule 1, item 1, section 832-400]*

1.212 The reverse hybrid mismatch rules apply to neutralise a hybrid mismatch of an entity if:

- apart from section 832-400, the entity would be entitled to an Australian income tax deduction in an income year in respect of the payment; and
- the deduction is the deduction component of a hybrid financial instrument mismatch to which the payment gives rise.

[Schedule 1, item 1, subsection 832-400(1)]

1.213 In these circumstances, the mismatch is neutralised by applying the Australian primary response to disallow the deduction to the extent that it does not exceed the amount of the reverse hybrid mismatch. *[Schedule 1, item 1, subsection 832-400(2)]*

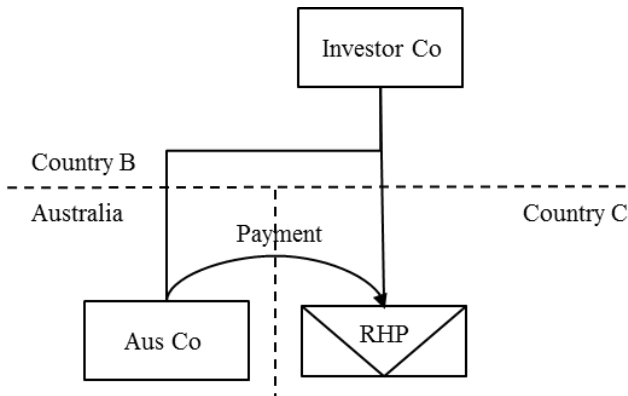
1.214 However, a reverse hybrid mismatch of an entity in respect of a payment is not neutralised under section 832-400 if:

- the scheme under which the payment is made is a structured arrangement to which the entity is not a party; and
- subsection 832-415(3) does not apply.

[Schedule 1, item 1, section 832-405]

Example of the operation of the reverse hybrid mismatch rules

Example 1.16: Payment gives rise to a reverse hybrid mismatch



Aus Co makes a deductible payment to a group member, RHP.

RHP is a partnership in Country C. Country C regards Investor Co as the liable entity in respect of RHP’s income or profits.

However, Country B regards RHP as a separate liable entity and therefore the payment is not subject to tax in Country B.

If the payment had been made directly by Aus Co to Investor Co, it would have been subject to tax in Country B.

Therefore, RHP is a reverse hybrid and the deductible payment is disallowed for Aus Co.

Branch hybrid mismatch (Subdivision 832-F)

1.215 The branch hybrid mismatch rules effectively implement Recommendation 2 of the OECD Branch Mismatch Arrangements Report.

What is a branch hybrid mismatch?

1.216 A payment gives rise to a **branch hybrid mismatch** if the payment gives rise to a hybrid mismatch under section 832-505 and either:

- the following entities are in the same Division 832 control group:
 - the entity that made the payment;
 - the branch hybrid; or
- the scheme under which the payment is made is a structured arrangement.

[Schedule 1, items 1 and 8, subsections 832-500(1), (3) and (4) and the definition of ‘branch hybrid mismatch’ in subsection 995-1(1)]

1.217 The deduction component of the branch hybrid mismatch is the deduction component of the deduction/non-inclusion mismatch mentioned in subsection 832-505. *[Schedule 1, item 1, subsection 832-500(2)]*

Interaction with other hybrid mismatch rules

1.218 A payment does not give rise to a branch hybrid mismatch if it gave rise to a hybrid financial instrument mismatch, a hybrid payer mismatch or a reverse hybrid mismatch. *[Schedule 1, item 1, section 832-505(3)]*

1.219 However, if a branch hybrid mismatch is an offshore hybrid mismatch, it might give rise to an imported hybrid mismatch. A branch hybrid mismatch is an offshore hybrid mismatch if:

- no deduction arises in respect of the mismatch;
- the country in which the foreign income tax deduction arose does not have foreign hybrid mismatch rules; and
- subsection 23AH(4A) of the ITAA 1936 does not apply in relation to the branch hybrid mismatch.

[Schedule 1, items 1 and 8, subsection 832-495(1) and the definition of ‘offshore hybrid mismatch’ in subsection 995-1(1)]

1.220 The amount of the offshore hybrid mismatch is the neutralising amount for the branch hybrid mismatch. *[Schedule 1, item 1, subsection 832-495(2)]*

When does a payment give rise to a hybrid mismatch under section 832-505?

1.221 A payment gives rise to a ***hybrid mismatch*** under section 832-505 if:

- the payment gives rise to a deduction/non-inclusion mismatch; and
- the mismatch, or a part of that mismatch, meets the hybrid requirement in section 832-510.

[Schedule 1, items 1 and 8, subsection 832-505(1) and definition of ‘hybrid mismatch’ in subsection 995-1(1)]

1.222 The amount of the hybrid mismatch is the lesser of:

- the amount of the deduction/non-inclusion mismatch; and
- if there is an excess under subparagraph 832-510(2)(b)(i) or (3)(b)(i) — the amount of the excess.

[Schedule 1, item 1, subsection 832-505(2)]

1.223 A payment meets the hybrid requirement in section 832-510 if the payment is made directly, or indirectly through one or more interposed entities, to a branch hybrid and:

- the residence country identified in subsection 832-515(2) is Australia; and
- either:
 - the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to Australian income tax for an income year was instead worked out on the assumption that the payment was instead treated as income derived by the liable entity but not in carrying on a business at or through a PE in another country for purposes of the Australian income tax law; or
 - on the same assumption, the payment would have given rise to a hybrid mismatch under section 832-215 (about hybrid financial instruments) or section 832-320 (about hybrid payers).

[Schedule 1, item 1, subsections 832-510(1), (2) and (4)]

1.224 A payment also meets the hybrid requirement in section 832-510 if the payment is made directly, or indirectly through one or more interposed entities, to a branch hybrid and:

- the residence country identified in subsection 832-515(2) is a foreign country; and
- either:
 - the amount of the deduction/non-inclusion mismatch exceeds the amount that would be the amount of that mismatch if the amount of the payment that was subject to foreign income tax for a foreign tax period was instead worked out on the assumption that the payment was instead treated as income derived by the liable entity but not in carrying on a business at or through a PE in another country for purposes of the Australian income tax law; or
 - the payment would have given rise to a hybrid mismatch under section 832-215 (about hybrid financial instruments) or section 832-320 (about hybrid payers).

[Schedule 1, item 1, subsections 832-510(1), (3) and (4)]

When is an entity a branch hybrid?

1.225 An entity is a branch hybrid, in relation to a payment made to the entity, if:

- subsection 832-515(2) applies to the entity in relation to the payment; and

- subsection 832-515(3) applies to the entity in relation to the payment.

[Schedule 1, items 1 and 8, section 832-515 and the definition of ‘branch hybrid’ in subsection 995-1(1)]

1.226 Subsection 832-515(2) applies to the entity in relation to the payment if:

- for a country (the residence country):
 - the entity is a liable entity in respect of its own income or profits; and
 - the entity satisfies the residency test in subsection 832-595(8);
- for that liable entity for the residence country, the payment is treated as income derived by the liable entity in carrying on a business at or through a PE in another country;
- as a result of an exemption or other tax concession to which that liable entity is entitled in respect of the income derived in carrying on a business at or through the PE:
 - if the residence country is Australia — the payment is not subject to Australian income tax; or
 - if the residence country is a foreign country — the payment is not subject to foreign income tax in that foreign country.

[Schedule 1, item 1, subsection 832-515(2)]

1.227 In this regard, for the purposes of determining whether paragraph 832-515(2)(c) is satisfied, the effect of subsection 23AH(4A) should be disregarded. In this regard, section 23AH generally applies to treat foreign branch income as non-assessable non-exempt income. Subsection 23AH(4A) has the effect of denying that exemption if the foreign income is branch hybrid mismatch income. *[Schedule 1, item 1, subsection 832-515(6)]*

1.228 Subsection 832-515(3) applies to the entity in relation to the payment if:

- the payment is treated as not having been derived in carrying on a business at or through a PE of the entity in the other country mentioned in paragraph 832-515(2)(b) (the branch country) for the purposes of:
 - if the branch country is Australia — the Australian income tax law; or
 - if the branch country is a foreign country — the law of the branch country in relation to foreign income tax (except

credit absorption tax, unitary tax or a withholding- type tax); and

- as a result:
 - if the branch country is Australia — the payment is not subject to Australian income tax; or
 - if the branch country is a foreign country — the payment is not subject to foreign income tax in that foreign country.

[Schedule 1, item 1, subsection 832-515(3)]

1.229 A PE is defined in subsection 6(1) of the ITAA 1936 to mean, broadly, a place at or through which a person carries on business.

1.230 However, the meaning of PE is modified if :

- the residence country and the branch country have entered into a treaty or other agreement relating to the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital (noting that if either the residence country or the branch country is Australia, the treaty or other agreement must be an international tax agreement in force under the *International Tax Agreements Act 1953*); and
- the agreement or treaty contains a permanent establishment article, or a provision corresponding to a permanent establishment article.

[Schedule 1, item 1, subsection 832-515(4)]

1.231 In these circumstances, a reference to a PE in a country is taken to be a reference to a permanent establishment (within the meaning to the relevant agreement or treaty) in the country. *[Schedule 1, item 1, subsection 832-515(5)]*

Consequences that arise if a payment gives rise to a branch hybrid mismatch

1.232 The branch hybrid mismatch rules apply to neutralise a branch hybrid mismatch of an entity if:

- apart from section 832-485, the entity would be entitled to an Australian income tax deduction in an income year in respect of the payment; and
- the deduction is the deduction component of a branch hybrid mismatch to which the payment gives rise.

[Schedule 1, item 1, subsection 832-485(1)]

1.233 In these circumstances, the mismatch is neutralised by applying the Australian primary response to disallow the deduction to the extent that it does not exceed the amount of the branch hybrid financial instrument mismatch. *[Schedule 1, item 1, subsection 832-485(2)]*

1.234 However, the mismatch is not neutralised under section 832-485 if subsection 23AH(2) does not apply in relation to the payment because of subsection 23AH(4A). *[Schedule 1, item 1, subsection 832-485(3)]*

1.235 In this regard, subsection 23AH(2) generally applies to treat foreign branch income as non-assessable non-exempt income. If subsection 23AH(4A) applies to a payment, the branch hybrid mismatch is effectively neutralised by the inclusion of an amount in assessable income for Australian income tax purposes.

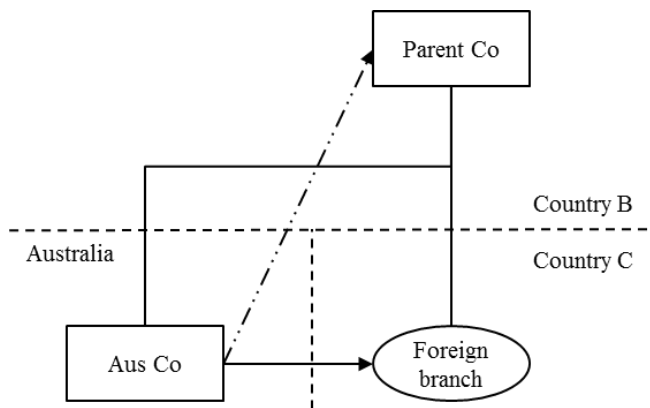
1.236 In addition, a branch hybrid mismatch is not neutralised under section 832-485 if:

- the scheme under which the payment is made is a structured arrangement to which the entity is not a party; and
- subsection 832-500(3) does not apply.

[Schedule 1, item 1, section 832-490]

Examples of the operation of the branch hybrid mismatch rules

Example 1.17: Payment gives rise to a branch hybrid mismatch — diverted branch payment



Aus Co makes a deductible payment to the foreign branch (Foreign Branch) of a group member, Parent Co.

Country B has a complete exemption for foreign branch profits.

In Country C, Parent Co is recognised as having a PE but the payment is regarded as having been paid to Parent Co in its own right, instead of being allocated to Foreign Branch.

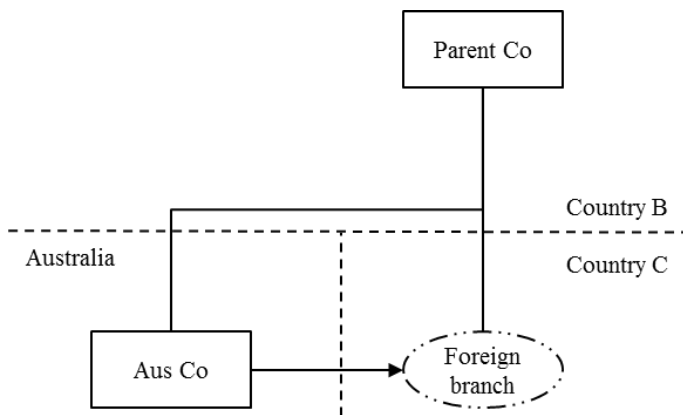
The payment is therefore not subject to foreign income tax in either Country B or Country C.

Parent Co is a branch hybrid because in Country B it is a resident and liable entity in respect of its own income and the payment is not subject to foreign income tax as a result of an exemption.

In Country C, the payment is not allocated to a PE of Parent Co (that is, it is not allocated to Foreign Branch). Therefore, the payment is not subject to foreign tax in Country C.

The hybrid requirement is met in this circumstance if the payment would have been subject to foreign income tax in Country B had it been derived by Parent Co, but not allocated as income derived through a PE for the purposes of its foreign branch exemption.

Example 1.18: Payment gives rise to a branch hybrid mismatch — disregarded branch structure



The facts are the same as for Example 1.17, except that Parent Co is not regarded as having a PE in Country C.

Therefore, the payment cannot be treated as having been derived through a PE in Country C.

Consequently, the payment is not subject to foreign tax in Country C.

Deducting hybrid mismatch (Subdivision 832-G)

1.237 The deducting hybrid mismatch rules effectively implement:

- Recommendation 6 of the OECD Action 2 Report; and
- Recommendation 4 of the OECD Branch Mismatch Arrangements Report.

What is a deducting hybrid mismatch?

1.238 An amount gives rise to a ***deducting hybrid mismatch*** if the amount gives rise to a deduction/deduction mismatch. [*Schedule 1, items 1 and 8, subsection 832-585(1) and the definition of ‘deducting hybrid mismatch’ in subsection 995-1(1)*]

1.239 Each deduction component of the deduction/deduction mismatch mentioned in subsection 832-585(1) is a deduction component of the deducting hybrid mismatch. *[Schedule 1, item 1, subsection 832-585(2)]*

1.240 A deducting hybrid mismatch is also a hybrid mismatch. *[Schedule 1, item 1, subsection 832-585(3)]*

Interaction with other hybrid mismatch rules

1.241 A payment does not give rise to a deducting hybrid mismatch if it gave rise to a hybrid financial instrument mismatch, a hybrid payer mismatch, a reverse hybrid mismatch, or a branch hybrid mismatch. *[Schedule 1, item 1, subsection 832-585(4)]*

1.242 However, if a deducting hybrid mismatch is an offshore hybrid mismatch, it might give rise to an imported hybrid mismatch. A deducting hybrid mismatch is an offshore hybrid mismatch if:

- no deduction arises in respect of the mismatch; and
- neither country in which a foreign income tax deduction arose has foreign hybrid mismatch rules.

[Schedule 1, items 1 and 8, subsection 832-580(1) and the definition of ‘offshore hybrid mismatch’ in subsection 995-1(1)]

1.243 The amount of the offshore hybrid mismatch is the neutralising amount for the deducting hybrid mismatch. *[Schedule 1, item 1, subsection 832-580(2)]*

When is an entity a deducting hybrid?

1.244 If an amount gives rise to a deduction/deduction mismatch, then the following is a ***deducting hybrid***:

- if the amount is a payment an entity makes — the entity that makes the payment;
- if the amount is an amount that represents a decline in the value of an asset — the entity that holds the asset; and
- if the amount is an amount that represents a share in the net loss of a partnership, trust or other transparent entity — the relevant partnership, trust or other transparent entity.

[Schedule 1, items 1 and 8, section 832-590 and the definition of ‘deducting hybrid’ in subsection 995-1(1)]

Identifying a primary response country and a secondary response country

1.245 If an amount gives rise to a deducting hybrid mismatch, it is generally necessary to identify a primary response country and a secondary response country in relation to the mismatch. *[Schedule 1, item 1, subsection 832-595(1)]*

1.246 However, it is not necessary to identify a secondary response country for a deducting hybrid mismatch if:

- the only liable entity in respect of the income or profits of the deducting hybrid is the deducting hybrid; and
- the liable entity satisfies the residency test in subsection 832-595(8) in both deducting countries — that is, if the liable entity is a dual resident.

[Schedule 1, item 1, subsection 832-595(2)]

1.247 A country in which an amount gives rise to an Australian income tax deduction or a foreign income tax deduction is a primary response country in relation to the deducting hybrid mismatch unless the country is identified as the secondary response country. *[Schedule 1, item 1, subsection 832-595(3)]*

1.248 A country in which a payment gives rise to an Australian income tax deduction or a foreign income tax deduction is a secondary response country in relation to the deducting hybrid mismatch if the country is identified as the secondary response country under subsection 832-595(4), (5), (6) or (7). *[Schedule 1, item 1, subsection 832-595(3)]*

1.249 Subsection 832-595(4) applies if:

- the deducting hybrid is the liable entity in each deducting country;
- in one deducting country, the deducting hybrid does not satisfy the residency test in subsection 832-595(8); and
- in the other deducting country, the deducting hybrid does satisfy the residency test in subsection 832-595(8).

[Schedule 1, item 1, subsection 832-595(4)]

1.250 In these circumstances, the country in which the deducting hybrid satisfies the residency test is the secondary response country. *[Schedule 1, item 1, subsection 832-595(4)]*

1.251 Subsection 832-595(5) applies if:

- the liable entity for one deducting country is a different entity to the entity that is the liable entity for the other deducting country; and
- in one deducting country, the deducting hybrid is the liable entity.

[Schedule 1, item 1, subsection 832-595(5)]

1.252 In these circumstances, the country in which the deducting hybrid is the liable entity is the secondary response country. *[Schedule 1, item 1, subsection 832-595(5)]*

- 1.253 Subsection 832-595(6) applies if:
- the liable entity for one deducting country is a different entity to the entity that is the liable entity for the other deducting country;
 - the deducting hybrid is not the liable entity in either country; and
 - in one deducting country (the first deducting country), the entity that is the liable entity is also a liable entity in respect of the income or profits of the entity that is the liable entity in the other deducting country.

[Schedule 1, item 1, subsection 832-595(6)]

1.254 In these circumstances, the first deducting country is the secondary response country. *[Schedule 1, item 1, subsection 832-595(6)]*

- 1.255 Subsection 832-595(7) applies if:
- the liable entity for one deducting country is a different entity to the entity that is the liable entity for the other deducting country;
 - subsections 832-595(5) and (6) do not apply; and
 - in one deducting country, the deducting hybrid and the liable entity both satisfy the residency test in subsection 832-595(8).

[Schedule 1, item 1, subsection 832-595(7)]

1.256 In these circumstances, the country in which deducting hybrid and the liable entity both satisfy the residency test is the secondary response country. *[Schedule 1, item 1, subsection 832-595(8)]*

- 1.257 An entity satisfies the residency test in subsection 832-595(8) if:
- if the country is Australia — the entity is an Australian entity; or
 - if the country is a foreign country:
 - the entity is a resident of the foreign country for the purposes of the law of the foreign country relating to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax); or
 - the tax base, as it relates to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax), includes income from worldwide sources.

[Schedule 1, item 1, subsection 832-595(8)]

Consequences that arise if a payment gives rise to a deducting hybrid mismatch

1.258 The deducting hybrid mismatch rules apply to neutralise a deducting hybrid mismatch of an entity if:

- apart from section 832-570, the entity would be entitled to an Australian income tax deduction in an income year in respect of the payment; and
- the deduction is the deduction component of a deducting hybrid mismatch to which the payment gives rise.

[Schedule 1, item 1, subsection 832-570(1)]

1.259 In these circumstances, the mismatch is neutralised by applying the Australian primary response to disallow the deduction to the extent that it does not exceed the amount of the deducting hybrid mismatch.

[Schedule 1, item 1, subsection 832-570(2)]

1.260 However, if Australia is the secondary response country, the deducting hybrid mismatch is not neutralised unless the secondary response is required under subsection 832-575(2) and:

- the following entities are in the same Division 832 control group:
 - the deducting hybrid; and
 - if one or more entities other than the deducting hybrid is a liable entity in respect of the income or profits of the deducting hybrid in a deducting country — each liable entity; or
- the scheme under which the payment is made is a structured arrangement.

[Schedule 1, item 1, subsections 832-575(1), (3) and (4)]

1.261 The secondary response is required under subsection 832-575(2) unless:

- a liable entity in respect of the income or profits of the deducting hybrid satisfies the residency test in subsection 832-595(8) in the primary response country; and
- the primary response country has foreign hybrid mismatch rules, or another law that has substantially the same effect as Australia's foreign hybrid mismatch rules.

[Schedule 1, item 1, subsection 832-575(2)]

What is the neutralising amount?

1.262 The neutralising amount for a deducting hybrid mismatch is the lesser of the amounts of each deduction or foreign income tax deduction to which the payment gives rise reduced by the amount of dual inclusion income that is available to be applied by subsection 832-600(1).

[Schedule 1, item 1, subsection 832-600(1)]

1.263 An amount of dual inclusion income is available to be applied to reduce the neutralising amount for a deducting hybrid mismatch to which section 832-570 applies if:

- the deducting hybrid is eligible to apply the amount (under subsection 832-740(7));
- the amount is subject to Australian income tax for the purposes of subsection 832-740(1) in the income year mentioned in subsection 832-570(1); and
- the amount is subject to foreign income tax for the purposes of subsection 832-740(1) in the foreign country in which the foreign income deduction tax arose.

[Schedule 1, item 1, subsection 832-600(2)]

1.264 An amount of dual inclusion income is available to be applied to reduce the neutralising amount for a deducting hybrid mismatch that is an offshore hybrid mismatch if:

- the deducting hybrid is eligible to apply the amount (under subsection 832-740(7));
- the amount is subject to foreign income tax for the purposes of subsection 832-740(1) in the foreign country in which one of the foreign income tax deductions arose and in the same foreign tax period; and
- the amount is also subject to foreign income tax for the purposes of subsection 832-740(1) in the foreign country in which another of the foreign income tax deductions arose.

[Schedule 1, item 1, subsection 832-600(3)]

Adjustment if deducting hybrid derives dual inclusion income in a later year

1.265 If a deducting hybrid derives dual inclusion income in a later year, an adjustment is made in that later income year to offset the neutralising amount.

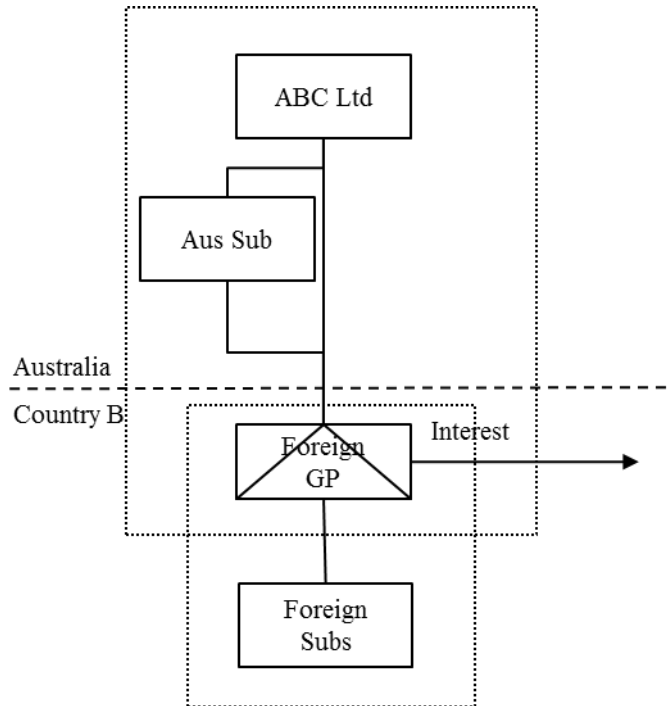
1.266 The adjustment applies for an entity for an income year (the adjustment year) if:

- in an earlier income year, all or part of a deduction of the entity in respect of a payment that gave rise to a deducting payer mismatch was not allowable under section 832-570;
- an amount of dual inclusion income is:
 - available to be applied by the deducting hybrid in the adjustment year;
 - subject to Australian income tax for the purposes of subsection 832-740(1) in the adjustment year; and
 - subject to foreign income tax for the purposes of subsection 832-740(1) in the foreign country in which the foreign income tax deductions arose.

[Schedule 1, item 1, subsection 832-605(1)]

1.267 In these circumstances, so much of the dual inclusion income that satisfies the requirement in paragraph 832-605(1)(b) as does not exceed the amount that was disallowed as a deduction can be deducted by the entity in the adjustment year. *[Schedule 1, item 1, subsection 832-605(2)]*

1.268 However, for the purposes of a later application of section 832-605, the amount that was disallowed as a deduction under section 832-570 is taken to be reduced by the amount deducted under subsection 832-605(2). *[Schedule 1, item 1, subsection 832-605(3)]*

*Examples of the operation of the deducting hybrid mismatch rules***Example 1.19: Deducting hybrid where Australia is the primary response country**

ABC Ltd is the head company of an Australian tax consolidated group. Aus Sub and Foreign general partnership are subsidiary members of the group.

Foreign GP is treated as a corporate entity in Country B and has an external interest expense.

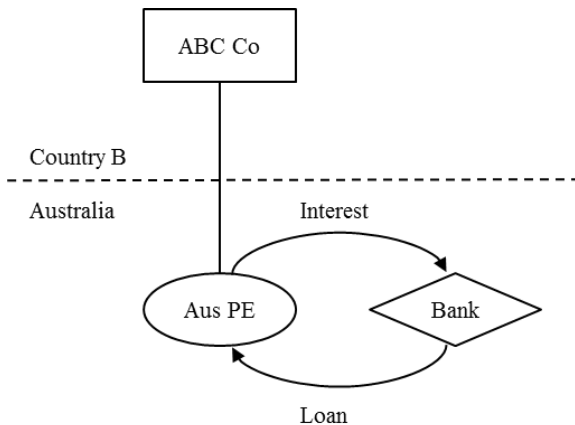
Foreign GP is a deducting hybrid in relation to the payment because the payment gives rise to both:

- a foreign income tax deduction; and
- a Australian income tax deduction for the Australian consolidated group.

The deduction is denied for the Australian consolidated group under section 832-570.

The secondary response conditions do not apply because the secondary response country identified in section 832-595 is Country B.

Example 1.20: Deducting hybrid where Australia is the secondary response country



ABC Co is a company resident in Country B and has a borrowing attributable to its Australian permanent establishment.

Country B taxes residents on worldwide income. Therefore, the interest is deductible for ABC Co in both Country B and in Australia. ABC Co is a deducting hybrid.

Australia is identified as the secondary response country under subsection 832-595(4) as ABC Co only satisfies the residency test in Country B.

Consequently, unless Country B has foreign hybrid mismatch rules or another law that has substantially the same effect as the hybrid mismatch rules, Australia would disallow the deduction.

The amount disallowed would be reduced to the extent of any dual inclusion income derived by ABC Co.

Imported hybrid mismatch (Subdivision 832-H)

1.269 The imported hybrid mismatch rules effectively implement:

- Recommendation 8 of the OECD Action 2 Report; and
- Recommendation 5 of the OECD Branch Mismatch Arrangements Report.

1.270 The key objective of the imported hybrid mismatch rules is to maintain the integrity of the other hybrid mismatch rules by removing any incentive for multinational groups to enter into hybrid mismatch arrangements (see paragraph 234 of the OECD Action 2 Report). The imported mismatch rule operates to disallow a broad range of payments (including interest, royalties, rents and payments for services) if the income from such payments is set-off, directly or indirectly, against a

deduction that arises under a hybrid mismatch arrangement in an offshore jurisdiction.

What is an imported hybrid mismatch?

- 1.271 A payment gives rise to an ***imported hybrid mismatch*** if:
- apart from section 832-660, the payment would give rise to an Australian income tax deduction for an entity for an income year;
 - the payment is an importing payment in relation to an offshore hybrid mismatch; and
 - the importing payment is eligible to neutralise the offshore hybrid mismatch.

[Schedule 1, items 1 and 8, subsection 832-665(1) and the definition of ‘imported hybrid mismatch’ in subsection 995-1(1)]

1.272 These three elements broadly align to the basic elements of the imported mismatch rule identified in paragraph 241 of the OECD Action 2 Report.

1.273 An imported hybrid mismatch is also a hybrid mismatch.

[Schedule 1, item 1, subsection 832-665(2)]

Interaction with other hybrid mismatch rules

1.274 A payment does not give rise to an imported hybrid mismatch if it gave rise to a hybrid financial instrument mismatch, a hybrid payer mismatch, a reverse hybrid mismatch, a branch hybrid mismatch or a deducting hybrid mismatch. *[Schedule 1, item 1, section 832-665(3)]*

1.275 However, for an imported hybrid mismatch to arise, a different payment must have given rise to an offshore hybrid mismatch that is a hybrid financial instrument mismatch, a hybrid payer mismatch, a reverse hybrid mismatch, a branch hybrid mismatch or a deducting hybrid mismatch.

What is an importing payment?

1.276 A payment an entity (the payer) makes is an ***importing payment*** in relation an offshore hybrid mismatch if:

- the payment is made directly, or indirectly through one or more interposed entities, to another entity; and
- the other entity (the offshore deducting entity) is:
 - the entity that made the payment that gave rise to the offshore hybrid mismatch; or
 - if the offshore hybrid mismatch is a deducting hybrid mismatch — the deducting hybrid.

[Schedule 1, items 1 and 8, subsection 832-670(1) and the definition of 'importing payment' in subsection 995-1(1)]

1.277 However, a payment is not an importing payment if the income or profits of the offshore deducting entity, the recipient of the payment the offshore deducting entity makes, or an interposed entity, are:

- subject to Australian income tax; or
- subject to foreign income tax in a country that has foreign hybrid mismatch rules.

[Schedule 1, item 1, subsection 832-670(2)]

1.278 Therefore, if a payment is made to an entity that is a tax resident in a country that has implemented foreign hybrid mismatch rules, there is no need to investigate the nexus of the payment to the offshore deducting entity.

1.279 In determining if a payment is made indirectly through an interposed entity to an offshore deducting entity, it is not necessary to demonstrate that each payment funds another. It is sufficient that payments exist between each interposed entity. However, the payments must be tax neutral (that is, assessable and deductible). Payments which are not deductible (such as ordinary equity distributions) are not taken into consideration when determining a nexus between payments.

1.280 For the purposes of determining whether a payment is made indirectly through one or more interposed entities to the offshore deducting entity:

- it is not necessary to demonstrate that each payment in a series of payments funds the next payment, or is made after the previous payment; and
- it is sufficient if payments exist between each interposed entity, and each of the payments give rise to a foreign income tax deduction (but not a deduction/non-inclusion mismatch).

[Schedule 1, item 1, subsection 832-670(3)]

Example 1.21: Nexus requirement for indirect importations

Aus Co is a member of the global XYZ Ltd group and has three sister companies:

- B Co, which is a resident of Country B — Country B has implemented hybrid mismatch rules;
- C Co, which is a resident of Country C — Country C has not implemented hybrid mismatch rules; and
- D Co, which is a resident of Country D — Country D has not implemented hybrid mismatch rules.

Aus Co makes deductible payments of \$100 in an subsequent income year to each of B Co, C Co and D Co.

In an overlapping foreign tax period:

- B Co and C Co each make deductible payments to D Co of \$100; and
- D Co makes a \$250 deductible payment to XYZ Ltd that gives rise to a hybrid financial instrument mismatch.

The payment Aus Co makes to B Co is not an importing payment because Country B has foreign hybrid mismatch rules.

The payments Aus Co and B Co make to D Co are both direct importing payments. As the sum of the payments (\$200) is less than the offshore hybrid deduction (\$250), the amount of the deduction denied to Aus Co for its payment to D Co is the lesser of the Australian income tax deduction and the result of the formula in section 832-680 — that is, \$100.

The payment Aus Co makes to C Co is an indirect importing payment (and therefore is covered by Item 3 in the table in subsection 832-675(3)). As C Co has offsetting foreign income tax deductions (being the payments to D Co), there is an indirect importation of the offshore hybrid mismatch to Aus Co. As this is the only payment identified as eligible to neutralise the mismatch within the same item in the table in section 832-675(3), the result of the formula in section 832-680 is:

$$\begin{aligned} & \frac{\text{Importing deduction by Aus Co}}{\text{Total importing deductions of equal priority}} \times \text{Remaining offshore hybrid mismatch} \\ &= \frac{\$100}{\$100} \times \$50 \\ &= \$50 \end{aligned}$$

1.281 For the purposes of working out whether a payment is an importing payment, a modification is made if:

- the payment is made to an entity (the first entity);
- another entity (the second entity) makes a payment (the second payment) to a third entity;
- the first entity and the second entity are in the same Division 832 control group;
- under a law of a foreign country relating to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax):

- a foreign income tax deduction arises in respect of the second payment; and
- the foreign income tax deduction may, as a result of a concessional feature of that law, be transferred to, shared with, or otherwise applied by the first entity.

[Schedule 1, item 1, subsection 832-670(4)]

1.282 In these circumstances, for the purposes of section 832-670:

- a payment is taken to have been made by the first entity to the second entity; and
- the payment is taken to have given rise to a foreign income tax deduction (but not a deduction/non-inclusion mismatch).

[Schedule 1, item 1, subsection 832-670(5)]

When is an importing payment eligible to neutralise an offshore hybrid mismatch?

1.283 An importing payment an entity makes is eligible to neutralise an offshore hybrid mismatch if:

- the payment, or part of the payment, gives rise to:
 - an Australian income tax deduction in an income year covered by subsection 832-675(2); or
 - a foreign income tax deduction, in a foreign country that has foreign hybrid mismatch rules, in a foreign tax period covered by subsection 832-675(2); and
- an item in the table in subsection 832-675(3) applies to the importing payment.

[Schedule 1, item 1, subsection 832-675(1)]

1.284 A foreign tax period or income year is covered by subsection 832-675(2) if it:

- ends at or after the end of the foreign tax period or income year in which the deduction component of the offshore hybrid mismatch arose; and
- has at least one day in common with the deducting period.

[Schedule 1, item 1, subsection 832-675(2)]

1.285 Table 1.1 sets out priority rules for importing payments. If more than one item in the table covers an importing payment in relation to offshore hybrid mismatch, the first item that covers it applies. However, an item does not apply to an importing payment if:

- an item higher in the table applies to one or more other importing payments in relation to the offshore hybrid mismatch; and
- the offshore hybrid mismatch is, or will be, fully neutralised by the application of the imported hybrid mismatch rule, and equivalent provisions of applicable foreign hybrid mismatch rules to those other importing payments.

[Schedule 1, item 1, subsection 832-675(3)]

Table 1.1: Priority table for importing payments

<i>Item</i>	<i>Topic</i>	<i>An importing payment is covered if:</i>
1	Structured arrangement	<ul style="list-style-type: none"> • the importing payment, the payment made by the offshore deducting entity, and each payment made by the interposed entity (if applicable) are made under a structured arrangement; and • the payer of the importing payment, the offshore deducting entity, and each interposed entity (if applicable) are all parties to the structured arrangement
2	Direct payment	<ul style="list-style-type: none"> • the importing payment is made directly to the offshore deducting entity; and • the payer of the importing payment and the offshore deducting entity are members of the same Division 832 control group
3	Indirect payment	<ul style="list-style-type: none"> • the importing payment is made indirectly through one or more interposed entities to the offshore deducting entity; and • the payer of the importing payment, the offshore deducting entity and each interposed entity are members of the same Division 832 control group

[Schedule 1, item 1, subsection 832-675(3)]

1.286 As noted in paragraphs 236 and 249 of the OECD Action 2 Report, an importing payment that arises under a structured arrangement (item 1 of Table 1.1) applies a tracing approach to determine if payments are made under the one arrangement and requires taxpayers to follow the flow of payments through tiers of entities and transactions that make up the arrangement. A structured arrangement imported hybrid mismatch can also arise within a Division 832 control group.

1.287 If the importing payment is a direct or indirect payment to the offshore deducting entity, the payer, the offshore deducting entity and each interposed entity must all be members of the same Division 832 control group. However, the scope requirements for the hybrid mismatch

payment made by the offshore deducting entity are the same as for the relevant hybrid mismatch rule.

1.288 For example, a hybrid financial instrument mismatch that arises because two entities are related (but not within the same Division 832 control group) could be neutralised by the direct or indirect imported mismatch rule, provided the payer of the importing payment and the offshore deducting entity are members of the same Division 832 control group.

Example 1.22: Priority of imported payments

From Example 1.21, assume instead the facts are as follows.

D Co issued the hybrid financial instrument to XYZ Ltd as part of setting up a group financing structure, which included raising funds needed for D Co's operations and monies needed for Aus Co's operations in Australia.

The monies for Aus Co's operation were provided by XYZ Ltd loaning an amount to C Co, which in turn on lent the amount to Aus Co. In this regard, a design feature of the scheme was that:

- the financial instrument issued by D Co would include specific terms to ensure it was treated as a debt instrument in Country D (meaning D Co could deduct the interest payments) but as an equity instrument for XYZ Ltd (meaning the interest payments were not subject tax in the hands of XYZ Ltd); and
- to on lend a portion of those funds to Australia through ordinary loans (via C Co), thereby importing the deductions into Aus Co.

The other payments in Example 1.21 are payments for intra-group services.

In the current year, the \$100 payment made by Aus Co to C Co, and in turn by C Co to D Co, relates to interest on the loans that were set up as part of the financing structure.

Therefore, the following payments are made under the structured arrangement:

- the deductible payment made by Aus Co to C Co — the importing payment;
- the deductible interest payments made by C Co to D Co — the payments made by the interposed entity; and
- the payment made by D Co to XYZ Ltd — the payment made by the offshore deducting entity.

Accordingly, the \$100 payment takes priority above the direct and indirect importations and, as it is less than the amount of the offshore

hybrid mismatch, \$100 of Aus Co's deductible payment to C Co is denied to Aus Co.

Consequently:

- the remaining offshore hybrid mismatch available to neutralise the direct importations is \$150; and
- applying the apportionment approach, the amount denied to Aus Co in respect of its deductible payment to D Co (for services) is \$75.

Working out the amount of an imported hybrid mismatch

1.289 The amount of the imported hybrid mismatch is the lesser of:

- the importing deduction amount in relation to the Australian income tax deduction; and
- the amount worked out using the following formula:

$$\frac{\text{Importing deduction}}{\text{Total importing deductions of equal priority}} \times \text{Remaining offshore hybrid mismatch}$$

[Schedule 1, item 1, subsection 832-680(1)]

1.290 In this formula, the factor *importing deduction* means the amount of the importing deduction amount in relation to the Australian income tax deduction.

1.291 The amount of the *remaining offshore hybrid mismatch* is generally the amount of the offshore hybrid mismatch. However, if an item higher in the table in subsection 832-675(3) applies to one or more other importing payments in relation to the offshore hybrid mismatch, the amount is the amount of the offshore hybrid mismatch that is not, or will not be, neutralised by the application of the imported hybrid mismatch rule, and equivalent provisions of applicable foreign hybrid mismatch rules, in relation to those other importing payments. *[Schedule 1, item 1, subsection 832-680(1)]*

1.292 The factor *total importing deductions of equal priority* means the amount worked out by:

- identifying each importing payment in relation to the offshore hybrid mismatch that is:
 - eligible to neutralise the mismatch; and
 - to which the same item in the table in subsection 832-675(3) applies;
- working out the amount of the importing deduction amount in relation to the Australian income tax deduction or foreign

income tax deduction to which each such importing payment gives rise; and

- summing the results for each importing payment.

[Schedule 1, item 1, subsection 832-680(1)]

1.293 The amount of the *importing deduction amount* in relation to an Australian income tax deduction or foreign income tax deduction is:

- if the importing payment is made directly to the offshore deducting entity — the amount of the Australian income tax deduction or foreign income tax deduction; or
- if the importing payment is made indirectly through one or more interposed entities to the offshore deducting entity — the lesser of:
 - the amount of the Australian income tax deduction or foreign income tax deduction; and
 - the smallest amount of any foreign income tax deduction to which a payment to an interposed entity gave rise.

[Schedule 1, item 1, subsection 832-680(2)]

1.294 The function of the formula in subsection 832-680(1) is to give effect to a priority approach and the apportionment methodology as noted in paragraphs 246 to 262 of the OECD Action 2 Report. Although the imported mismatch rule does not require taxpayers to specifically trace a use of funds, it will be necessary to first determine whether a payment is part of a structured arrangement, as such payments are denied in priority to direct and indirect imported mismatches.

Example 1.23: Apportionment of hybrid mismatch deductions between importing payments

D Co, from Example 1.21, has a hybrid financial instrument mismatch in respect of a payment to XYZ Ltd of \$150 in a particular foreign tax period.

In an overlapping income year and foreign tax periods, Aus Co, B Co and C Co have all made deductible payments to D Co of \$100.

Aus Co's and B Co's deductible payments of \$100 are both eligible to neutralise the offshore hybrid mismatch as direct payments under Item 2 of the priority table in subsection 832-675(3).

C Co's payment is not eligible to neutralise the offshore hybrid mismatch as it is neither an Australian income tax deduction nor a foreign income tax deduction in a foreign country that has foreign hybrid mismatch rules.

The amount of the imported hybrid mismatch for Aus Co is \$75, worked out by applying the formula in section 832-680(1)(b) as follows:

$$\begin{aligned} & \frac{\text{Importing deduction by Aus Co}}{\text{Total importing deductions of equal priority}} \times \text{Remaining offshore hybrid mismatch} \\ &= \frac{\$100}{\$200} \times \$150 \\ &= \$75 \end{aligned}$$

Consequences that arise if a payment gives rise to an imported hybrid mismatch

1.295 If a payment gives rise to an imported hybrid mismatch and, apart from section 832-660, an entity would be entitled to an Australian income tax deduction in an income year in respect of the payment, then the mismatch is neutralised by disallowing the deduction to the extent that it does not exceed the amount for the imported hybrid mismatch.

[Schedule 1, item 1, section 832-660]

1.296 An imported hybrid mismatch may be carried forward if:

- a payment made in a particular foreign tax period gave rise to an offshore hybrid mismatch (the original mismatch); and
- the original mismatch is only partly neutralised by the application of the imported hybrid mismatch rules and equivalent provisions of applicable foreign hybrid mismatch rules.

[Schedule 1, item 1, subsection 832-685(1)]

1.297 In these circumstances, the imported hybrid mismatch rules apply as if:

- the offshore deducting entity had made a payment in the next foreign tax period;
- the payment gave rise to an offshore hybrid mismatch (the residual mismatch); and
- the amount of the residual mismatch was the amount of the original mismatch that was not neutralised by the application of the imported hybrid mismatch rules and equivalent provisions of applicable foreign hybrid mismatch rules.

[Schedule 1, item 1, subsection 832-685(2)]

Integrity rule where payments are made to an interposed foreign entity

1.298 In the 2017-18 MYEFO, the Government announced an extension of the OECD hybrid mismatch rules to introduce a targeted integrity rule to prevent multinational groups from being able to enter into arrangements designed to circumvent the hybrid mismatch rules.

1.299 The targeted integrity rule will prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed conduit type entities that pay effectively no tax to invest into Australia, as an alternative to investing directly into Australia via traditional hybrid instruments or entities. These structures can be used to effectively replicate a deduction/non-inclusion outcome.

1.300 Therefore, regard should be had to the potential application of this targeted integrity rule where there are intra-group financing arrangements within multinational groups involving:

- routing of funds through foreign interposed entities which result in an Australian income tax deduction (for example, interest on a loan); and
- the imposition of foreign income tax on the payment at a rate of 10 per cent or less.

When does the integrity rule apply?

1.301 The integrity rule will apply if:

- an entity (the paying entity) makes a payment under a scheme to a foreign entity (the interposed foreign entity) either directly or indirectly through one or more interposed Australian trusts of or Australian partnerships;
 - A trust is an Australian trust if it satisfies the definition in section 338 of the ITAA 1936. A partnership is an Australian partnership if it satisfies the definition in section 337 of that Act.
- the paying entity, the interposed foreign entity and another foreign entity (the ultimate parent entity) are in the same Division 832 control group;
- the ultimate parent entity is the entity in the Division 832 control group that is not controlled by any other member of the group;
- the interposed foreign entity and the ultimate parent entity are not residents of the same foreign country;
- the payment is:

- an amount of interest within the meaning in subsection 128A(1AB) of the ITAA 1936 — the term interest is defined in that subsection to include, among other things, an amount in the nature of interest and an amount that could reasonably be regarded as having been converted into a form that is in substitution for interest; or
- an amount under a derivative financial arrangement;
- the paying entity is (disregarding section 832-800) entitled to an Australian income tax deduction in an income year in respect of the payment; and
- either:
 - the payment is subject to foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax) in the country of residence of the interposed foreign entity at a rate (the interposed country rate) that is 10 per cent or less; or
 - the payment is not subject to foreign income tax.

[Schedule 1, item 1, subsection 832-800(1)]

1.302 For these purposes, an entity (the original paying entity) is taken to have made a payment of an amount of interest or an amount under a derivative financial arrangement to a foreign entity if:

- the original paying entity makes a payment of this kind to another entity;
- the other entity, or a further entity, pays an amount of that kind to the foreign entity; and
- these payments are made under an arrangement involving back-to-back loans or an arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.

[Schedule 1, item 1, subsections 832-800(7) and (8)]

Example 1.24: When the integrity rule will not apply — failing the primary conditions

Aus Co makes a deductible interest payment to Interposed Foreign Co (which is a foreign company resident in Country B). Both Aus Co and Interposed Foreign Co are members of the Global Co Division 832 control group. Global Co is a resident of Country C and is the ultimate parent entity.

Interposed Foreign Co is subject to foreign income tax on the interest payment at a rate of 15 per cent. Interposed Foreign Co is entitled to a foreign tax credit for the 10 per cent Australian interest withholding tax on the interest payment.

The integrity rule does not apply because the payment is not subject to foreign income tax at a rate of 10 per cent or less (and therefore the condition in paragraph 832-800(1)(g) is not satisfied).

Example 1.25: When the positive conditions in the integrity rule will be satisfied

Assume the facts are the same as in Example 1.24 except that Interposed Foreign Co is not subject to foreign income tax on the payment because Country B does not impose income tax on any foreign income derived by its residents.

The positive conditions in subsection 832-800(1) are met. Therefore, the integrity rule will apply unless one of the specified exceptions applies.

1.303 However, the integrity rule will not apply if any one of three exceptions applies.

1.304 First, the integrity rule will not apply if it is reasonable to conclude that the amount of the payment is:

- included under the controlled foreign company provisions (section 456 or 457 of the ITAA 1936) in the assessable income of an entity; or
- included under a corresponding provision of a law of a foreign country in working out the tax base of an entity.

[Schedule 1, item 1, subsection 832-800(3)]

1.305 Second, the integrity rule will not apply if it is reasonable to conclude that, assuming that the payment had been made directly to the ultimate parent entity:

- the payment would:
 - be subject to foreign income tax at a rate that is the same as, or less than, the interposed country rate; or
 - not be subject to foreign income tax; and
- the payment would not give rise to a hybrid financial instrument mismatch, a hybrid payer mismatch or a reverse hybrid mismatch.

[Schedule 1, item 1, subsection 832-800(4)]

Example 1.26: When the integrity rule will not apply — satisfying the second exception

Assume the facts are the same as in Example 1.25. However, if Aus Co paid the interest payment directly to Global Co, Global Co would not have been subject to foreign income tax on the interest payment in Country C.

As the interest income would have been subject to foreign income tax in the hands of the ultimate parent entity at a rate that is the same as, or less than the interposed country rate, the integrity rule does not apply.

1.306 Third, the integrity rule will not apply if it is reasonable to conclude that the scheme was not designed to produce:

- an Australian income tax deduction in relation to the payment; and
- the imposition of foreign income tax on the payment at a rate of 10 per cent or less, or the absence of the imposition of foreign income tax on the payment.

[Schedule 1, item 1, subsection 832-800(5)]

1.307 The question as to whether the scheme has been designed to produce these effects must be determined by reference to the facts and circumstances that exist in connection with the scheme, including the terms of the scheme. *[Schedule 1, item 1, subsection 832-800(6)]*

1.308 In this regard, factors that may be relevant in determining whether it would be reasonable to conclude that the scheme was designed to produce the imposition of foreign income tax on the payment at a rate of 10 per cent or less include, for example, whether the foreign entity that receives the payment:

- undertakes a group financing function;
- acts as a regional holding company, with substantial economic activity in the other jurisdiction; or
- carries on substantial economic activities in the other jurisdictions.

Example 1.27: When the integrity rule will not apply — regional holding company function

Aus Co makes a deductible interest payment to Regional Hold Co (which is a resident in Country B). Both Aus Co and Regional Hold Co are members of the Global Co Division 832 control group. Global Co (which is a resident in Country A) is the ultimate parent entity.

Country A imposes tax on foreign source interest payments at a rate greater than 10 per cent. Country B does not impose income tax on any foreign income derived by its residents.

Regional Hold Co undertakes a holding company function for the Global Co group for the Asia-Pacific region and has conducted this function since its inception. This function includes holding shares and lending to a number of subsidiaries operating in the Asia-Pacific region, including Aus Co.

Regional Hold Co was established prior to its acquisition of Aus Co, which was funded primarily via Regional Hold Co's surplus cash reserves at the time.

Regional Hold Co has employees in Country B who undertake substantial economic activities on behalf of the company and its Board can demonstrate that it undertakes the decision making functions expected of a regional holding company.

In this regard, the provision of debt financing by Regional Hold Co to its subsidiaries is part of its ordinary functions as a regional holding company.

Therefore, this would indicate that it would not be reasonable to conclude that the scheme, involving the establishment of Regional Hold Co and the funding of Aus Co, was designed to produce the outcomes identified in subsection 832-800(5).

Example 1.28: When the integrity rule will not apply — group financing function

Group Finance Co conducts a function of providing finance (long term and short term) to Global Co group members. It has mixed sources of funding to support its on-lending function, including:

- external debt funding;
- equity provided from Global Co; and
- interest bearing loans provided by various group members that have surplus funds.

Group Finance Co has employees in Country C with the relevant expertise to carry out its borrowing and on lending functions and can demonstrate that funding used to lend to Aus Co was not effectively funded via a capital injection from Global Co.

On balance, these facts regarding Group Finance Co's source of funds and its ordinary business function would indicate that it would not be reasonable to conclude that the scheme was designed to produce the outcomes identified in subsection 832-800(5).

Example 1.29: When the integrity rule will apply — conduit financing

Aus Co, from Example 1.25, makes a deductible interest payment to Sister Co (a resident in Country D).

Country D does not impose any income tax. Sister Co was established shortly prior to making the loan to Aus Co and funded solely with equity funding from Global Co.

In the absence of other facts, the relevant scheme would include:

- the establishment of Sister Co by Global Co with equity; and
- the on-lending by Sister Co to Aus Co.

Therefore, it would be reasonable to conclude that the scheme was designed to produce the outcome of allowing a deduction for Aus Co for a payment which was not subject to foreign tax.

What consequences arise if the integrity rule applies?

1.309 If the integrity rule applies, the paying entity is not entitled to the deduction mentioned in paragraph 832-800(1)(f). [*Schedule 1, item 1, subsection 832-800(2)*]

Interaction with the TOFA provisions

1.310 Specific provisions clarify the operation of Division 832 for TOFA gains and losses so that:

- the OECD hybrid mismatch rules in Division 832 do not apply to the foreign currency exchange rate component of a TOFA gain or loss; and
- the amount of a TOFA gain or loss is adjusted where OECD hybrid mismatch rules have the effect of adjusting the amount of that gain or loss.

Foreign currency exchange rate component of a TOFA gain or loss

1.311 The modifications to TOFA gains and losses apply to:

- a gain that, apart from the OECD hybrid mismatch rules, would be included in an entity's assessable income for an income year under the TOFA provisions (Division 230);
- a loss that, apart from the OECD hybrid mismatch rules, would be allowable as a deduction to an entity for an income year under the TOFA provisions; and
- a gain or loss from a hedging financial arrangement that, apart from the OECD hybrid mismatch rules, would be dealt with in accordance with subsection 230-310(4) in relation to an income year.

[*Schedule 1, item 1, subsection 832-850(1)*]

1.312 If the modification applies then, for the purposes of the OECD hybrid mismatch rules, the gain or loss must be split as follows:

- to the extent that the gain or loss represents a currency exchange rate effect, the gain or loss is treated as a separate gain or loss; and
- to the extent that the gain or loss does not represent a currency exchange rate effect, the gain or loss is treated as a separate gain or loss from the financial arrangement.

[*Schedule 1, item 1, subsection 832-850(2)*]

1.313 For the purposes of the OECD hybrid mismatch rules, it is assumed that an amount treated under paragraph 832-850(2)(b) as a separate loss would, apart from these rules, be allowable as a deduction to the entity for the income year. *[Schedule 1, item 1, subsection 832-850(3)]*

1.314 In these circumstances, a modification applies if:

- there is a loss from a financial arrangement (including an amount that is treated as a separate loss);
- in working out the amount of the loss:
 - all or part of the payment made, or to be made, to another entity is taken into account; or
 - two or more payments made, or to be made, to another entity are taken into account.

[Schedule 1, item 1, subsection 832-850(4)]

1.315 In these circumstances, the OECD hybrid mismatch rules apply as if there was a single payment, made to another entity (the recipient), and giving rise to a deduction that is a foreign income tax deduction.

[Schedule 1, item 1, subsection 832-850(4)]

1.316 However, if a provision of the OECD hybrid mismatch rules would apply to make an amount that is all or part of the deduction not allowable:

- that provision does not apply; and
- section 230-522 applies instead.

[Schedule 1, item 1, subsection 832-850(5)]

1.317 In addition, if there is an amount treated as a separate gain from a financial arrangement, the gain is treated as consisting of any actual payments made under the financial arrangement and taken into account in working out the gain or loss the entity made from the arrangement.

[Schedule 1, item 1, subsection 832-850(6)]

1.318 In these circumstances, the OECD hybrid mismatch rules apply as if the gain is an amount that is included in the entity's assessable income. *[Schedule 1, item 1, subsection 832-850(7)]*

Amount of a TOFA gain or loss adjusted where OECD hybrid mismatch rules apply

1.319 If a provision in Division 832 would apply to make an amount that is all or part of the deduction not allowable, the amount of a TOFA gain or loss is adjusted.

1.320 To achieve this, section 230-522 applies if:

- for the purposes of the OECD hybrid mismatch rules, section 832-850 applies to treat:
 - a part of a gain or loss made from a financial arrangement as a separate loss from the financial arrangement; and
 - the separate loss as being deductible; and
- disregarding section 230-522, a provision of the OECD hybrid mismatch rules would apply to make an amount (the relevant amount) that is all or part of the deduction not allowable.

[Schedule 1, item 71, subsection 230-522(1)]

1.321 In these circumstances:

- if (disregarding section 832-850) a loss is made from the financial arrangement, and the relevant amount does not exceed the amount of the loss — the amount of the loss is reduced by the relevant amount;
- if (disregarding section 832-850) a loss is made from the financial arrangement, and the relevant amount exceeds the amount of the loss — a gain equal to the amount of the excess (instead of a loss) is taken to be made from the financial arrangement; or
- if (disregarding section 832-850) a gain is made from the financial arrangement — the amount of the gain is increased by the relevant amount.

[Schedule 1, item 7, subsection 230-522(2)]

Interaction with the controlled foreign company provisions

1.322 Section 389 of the ITAA 1936 applies to ensure that certain provisions are disregarded for the purposes of calculating the attributable income of a controlled foreign company.

1.323 A consequential amendment ensures that the OECD hybrid mismatch rules in Division 832 are disregarded for these purposes.

[Schedule 1, item 6, section 389 of the ITAA 1936]

Application and transitional provisions

1.324 The amendments to implement the OECD hybrid mismatch rules apply to payments made on or after the day that is six months after the day that this Bill receives the Royal Assent.

Chapter 2

Branch mismatch arrangements

Outline of chapter

- 2.1 Schedule 1 to this Bill also amends the ITAA 1936 to:
- limit the scope of the exemption for foreign branch income; and
 - prevent a deduction from arising for payments made by an Australian branch of a foreign bank to its head office in some circumstances.
- 2.2 All references in this chapter are to the ITAA 1936 unless otherwise stated.

Context of amendments

- 2.3 In the 2017-18 MYEFO, the Government announced an extension of the OECD hybrid mismatch rules to implement the recommendations in the OECD Branch Mismatch Arrangements Report.
- 2.4 The amendments in Schedule 1 to this Bill also implement Recommendations 1 and 3 of the OECD Branch Mismatch Arrangements Report.

Recommendation 1 of the OECD Branch Mismatch Arrangements Report

- 2.5 Recommendation 1 of the OECD Branch Mismatch Arrangements Report is as follows:
- Jurisdictions that provide an exemption for branch income should consider limiting the scope and operation of this exemption so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction, are properly taken into account under the laws of the residence jurisdiction.
- 2.6 However, paragraph 35 of the OECD Branch Mismatch Arrangements Report notes that:
- Recommendation 1.1 is based on the assumption that the intention of the residence jurisdiction in granting an exemption for branch income is to relieve that income from double taxation, so that income that is not, in fact, subject to net taxation in the branch jurisdiction should not benefit from this exemption. Recommendation 1 should not, however,

be interpreted as requiring countries to make any change to deliberate policy decisions they have made, including in respect of the territorial scope of their tax regime. Accordingly, this recommendation only calls for jurisdictions to consider modifying the scope and operation of their branch exemption to neutralise branch mismatches and does not set out any limitations on the amount of the adjustment, or the mechanism for making that adjustment, provided any adjustment is consistent with a jurisdiction's tax treaty obligations, and tax policy settings in that jurisdiction.

2.7 Under section 23AH, certain foreign branch income derived by an Australian resident company in carrying on a business through a foreign PE (a foreign branch) is non-assessable non-exempt income in certain circumstances.

2.8 Therefore, to implement Recommendation 1 of the OECD Branch Mismatch Arrangements Report, section 23AH is being modified to limit the scope of the exemption for foreign branch income.

Recommendation 3 of the OECD Branch Mismatch Arrangements Report

2.9 Recommendation 3 of the OECD Report on Neutralising the Effects of Branch Mismatch Arrangements is as follows:

The jurisdiction that recognises a deemed branch payment (the payer jurisdiction) should deny that deduction to the extent that it gives rise to a branch mismatch.

A deemed branch payment is a deemed payment between the branch and the head office or between two branches of the same taxpayer that gives rise to a deduction/non-inclusion outcome as a result of the fact that such payment is disregarded under the laws of the jurisdiction that is treated as receiving the payment (the payee jurisdiction).

A deemed branch payment shall give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income.

2.10 Deductions for deemed payments by a branch to its parent are generally not a feature of the Australian income tax law. However, an exception applies for Australian branches of foreign banks (Part IIIB). In this regard, under Part IIIB, an Australian branch of a foreign bank is treated as a separate taxpayer.

2.11 As a result, foreign bank notional payments of interest by a Australian branch to the foreign bank are taken to have been incurred by the Australian branch, paid by the Australian branch to the foreign bank, and derived by the foreign bank in respect of the notional borrowing (section 160ZZZA).

2.12 In addition, notional derivative transactions entered into by the Australian branch to the foreign bank are recognised (section 160ZZZE).

2.13 The same treatment applies to Australian branches of foreign financial entities (section 160ZZZK).

2.14 Therefore, to implement Recommendation 3 of the OECD Branch Mismatch Arrangements Report, Part IIIB is being modified to prevent a deduction from arising for payments made by an Australian branch of a foreign bank to the foreign bank in some circumstances.

Summary of new law

2.15 Schedule 1 to this Bill also amends the ITAA 1936 to:

- limit the scope of the exemption for foreign branch income; and
- prevent a deduction from arising for payments made by an Australian branch of a foreign bank to its head office in some circumstances.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Foreign branch income that is branch hybrid mismatch income derived by the Australian resident company will be assessable income.	Foreign branch income derived by an Australian resident company in carrying on a business through a foreign PE (a foreign branch) is non-assessable non-exempt income in certain circumstances.
An Australian branch of a foreign bank cannot deduct notional payments of interest made to the foreign bank or an amount paid in respect of a notional derivative transaction for an income year unless the payment gives rise to dual inclusion income in that income year. A deduction may be allowed for the amount in a later income year in which the Australian branch derives dual inclusion income.	An Australian branch of a foreign bank can deduct notional payments of interest made to the foreign bank. In addition, notional derivative transactions entered into by the Australian branch to the foreign bank are recognised for income tax purposes.

Detailed explanation of new law

Limit the scope of the branch exemption

2.16 Consistent with Recommendation 1 of the OECD Branch Mismatch Arrangements Report, section 23AH is being modified to limit the scope of the exemption for foreign branch income.

2.17 Foreign income derived by an Australian resident company that is carrying on business at or through a PE in a foreign country is generally non-assessable non-exempt income of the company (subsection 23AH(2)).

2.18 The amendments ensure that subsection 23AH(2) does not apply to foreign income that would otherwise give rise to a branch hybrid mismatch. *[Schedule 1, items 2 and 3, paragraph 23AH(1)(d) and subsection 23AH(4A)]*

2.19 A company has a branch hybrid mismatch income if it derives foreign income that, for the purposes of the OECD hybrid mismatch rules in Division 832 of the ITAA 1997, is a payment received by the company that, apart from subsection 23AH(4A), would give rise to a branch hybrid mismatch. The amount of branch hybrid mismatch income is equal to the amount of the foreign income to the extent that it does not exceed the amount of the branch hybrid mismatch. *[Schedule 1, item 4, subsection 23AH(14C)]*

2.20 For the purposes of section 23AH, a reference to a PE in the branch hybrid mismatch rules in Division 832 of the ITAA 1997 is taken to have the same meaning as in subsection 23AH(15). *[Schedule 1, item 4, subsection 23AH(14D)]*

Deemed branch payment rule

2.21 Consistent with Recommendation 3 of the OECD Branch Mismatch Arrangements Report, Part IIIB is being modified to prevent a deduction from arising for payments made by an Australian branch of a foreign bank to the foreign bank in some circumstances.

2.22 The modification applies if:

- either:
 - an amount of interest (a notional payment) in respect of a notional borrowing is taken under section 160ZZZA to be incurred or paid by an Australian branch to a foreign bank; or
 - an amount (also a notional payment) is taken under section 160ZZZE to be an amount paid by an Australian branch to a foreign bank in respect of a notional derivative transaction;

- the amount would (apart from section 160ZZZL) give rise to an Australian income tax deduction for the Australian branch for an income year; and
- the amount of the Australian income tax deduction exceeds the amount worked out under subsection 160ZZZL(3).

[Schedule 1, item 5, subsection 160ZZZL(1)]

2.23 The amount worked out under subsection 160ZZZL(3) is the sum of:

- the amount of the notional payment that is subject to foreign income tax;
- so much (if any) of the notional payment that it is reasonable to conclude is effectively funding non-deductible third party expenses; and
- the amount (if any) of income or profits of the Australian branch that is both:
 - subject to Australian income tax for the purposes of subsection 832-740(1) of the ITAA 1997 in the relevant income year; and
 - subject to foreign income tax for the purposes of that subsection in the foreign country in which the foreign bank is resident.

[Schedule 1, item 5, subsection 160ZZZL(3)]

2.24 If the notional payment is in respect of a notional borrowing and it is reasonable to conclude that the notional borrowing is effectively funded by actual borrowings of the foreign bank, then the expenses in respect of the actual borrowings are non-deductible third party expenses to the extent (if any) that those expenses do not give rise to foreign income tax deductions. *[Schedule 1, item 5, subsection 160ZZZL(4)]*

2.25 If the notional payment is in respect of a notional derivative transaction and it is reasonable to conclude that the foreign bank has hedged or managed all or part of its risk in respect of the notional derivative transaction by entering into actual transactions, then the expenses in respect of the actual transactions are non-deductible third party expenses to the extent (if any) that those expenses do not give rise to foreign income tax deductions. *[Schedule 1, item 5, subsection 160ZZZL(5)]*

2.26 If the modification applies, then so much of the Australian income tax deduction as equals the excess worked out under paragraph 160ZZZL(1)(c) is not allowable as a deduction in the income year. *[Schedule 1, item 5, subsection 160ZZZL(2)]*

2.27 However, if subsection 160ZZZL(2) applies to deny a deduction for an amount for an income year, the amount may be deductible in a later income year (the adjustment year) in which the Australian branch derives dual inclusion income. That is, the Australian branch may be able to deduct an amount in the adjustment year if an amount of income or profits of the Australian branch is both:

- subject to Australian income tax for the purposes of subsection 832-740(1) of the ITAA 1997 in the adjustment year; and
- subject to foreign income tax for the purposes of that subsection in the foreign country in which the foreign bank is resident.

[Schedule 1, item 5, subsection 160ZZZN(1)]

2.28 In these circumstances, the Australian branch can deduct in an adjustment year an amount equal to so much of income or profits that satisfies paragraph 160ZZZL(1)(c) to the extent that it does not exceed the amount that was not allowable. *[Schedule 1, item 5, subsection 160ZZZN(2)]*

2.29 For the purposes of a later application of section 160ZZZN, an amount of a deduction that was not allowable under subsection 160ZZZL(2) is reduced by the amount deducted under subsection 160ZZZN(2). This is to ensure that a deduction for the amount is allowed only once. *[Schedule 1, item 5, subsection 160ZZZN(3)]*

2.30 In addition, to ensure that dual inclusion income is applied only once:

- for the purposes of paragraphs 160ZZZL(3)(c) and 160ZZZN(1)(c), an amount of income or profits is disregarded if the amount is dual inclusion income that has been applied by a provision of Division 832 of the ITAA 1997; and
- for the purposes of Division 832, an amount of dual inclusion income is not available to be applied by a provision of that Division if it has been taken into account under paragraph 160ZZZL(3)(c) or subsection 160ZZZN(2).

[Schedule 1, item 5, section 160ZZZP]

2.31 The following terms that are used in sections 160ZZZL, 160ZZZN and 160ZZZP have the same meaning as in Division 832 of the ITAA 1997:

- dual inclusion income;
- foreign income tax deduction;
- foreign tax period;

- subject to Australian income tax; and
- subject to foreign income tax

[Schedule 1, item 5, section 160ZZZR]

Application and transitional provisions

2.32 The amendments to implement the OECD hybrid mismatch rules apply to payments made on or after the day that is six months after the day that this Bill receives the Royal Assent.

Chapter 3

Other effects of foreign income tax deductions

Outline of chapter

- 3.1 Schedule 2 to this Bill amends the ITAA 1997 to:
- deny imputation benefits on franked distributions made by an Australian corporate tax entity if all or part of the distribution gives rise to a foreign income tax deduction; and
 - prevent certain foreign equity distributions received, directly or indirectly, by an Australian corporate tax entity from being non-assessable non-exempt income if all or part of the distribution gives rise to a foreign income tax deduction.
- 3.2 All references in this chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

3.3 In the 2016-17 Budget, the Government announced that it would implement the recommendations made in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation (see Chapter 1). These recommendations include modifications to the domestic income tax law to:

- deny imputation benefits on franked distributions made by an Australian corporate tax entity if all or part of the distribution gives rise to a foreign income tax deduction; and
- prevent certain foreign equity distributions received, directly or indirectly, by an Australian corporate tax entity from being non-assessable non-exempt income if all or part of the distribution gives rise to a foreign income tax deduction.

3.4 These modifications are consistent with Recommendation 2 of the OECD Action 2 Report.

3.5 In the 2017-18 Budget, the Government further announced that it would eliminate hybrid tax mismatches that occur in cross border transactions relating to Additional Tier 1 regulatory capital. Transitional rules for Additional Tier 1 capital instruments issued before 9 May 2017 were also announced.

Summary of new law

3.6 Consistent with the OECD Action 2 Report and the Board of Taxation recommendations, Schedule 2 to this Bill makes amendments to:

- deny imputation benefits on franked distributions made by an Australian corporate tax entity if all or part of the distribution gives rise to a foreign income tax deduction; and
- prevent a foreign equity distribution from a foreign company that is received, directly or indirectly, by an Australian corporate tax entity that holds a participation interest of at least 10 per cent in the foreign company from being non-assessable non-exempt income if all or part of the distribution gives rise to a foreign income tax deduction.

3.7 Transitional rules apply to Additional Tier 1 capital instruments issued by authorised deposit-taking institutions before 9 May 2017. Under these transitional rules, the amendments to deny imputation benefits do not apply in relation to distributions on the instrument that are made before the first available call date of the instrument that occurs on or after 9 May 2017.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>An entity that receives a franked distribution is denied access to imputation benefits if all or part of the distribution gives rise to a foreign income tax deduction.</p>	<p>Under the company imputation system, when an Australian corporate tax entity distributes profits to its members, the entity has the option of passing credit for income tax paid by the entity on those profits to those members. This is done by franking the distribution.</p> <p>When the Australian corporate tax entity makes a franked distribution, the entity must make a debit to its franking account. The amount of the debit is equal to the amount of the franking credit on the distribution.</p> <p>If a member of an entity receives a franked distribution:</p> <ul style="list-style-type: none"> • an amount equal to the amount of the franking credit is generally included in the member’s assessable income (in addition to the amount of the distribution);

<i>New law</i>	<i>Current law</i>
	and <ul style="list-style-type: none"> • the member is generally entitled to a tax offset equal to the amount of the franking credit.
<p>A foreign equity distribution from a foreign company that is received by an Australian corporate tax entity, either directly or indirectly through one or more interposed trusts or partnerships, is generally non-assessable non-exempt income if the Australian corporate tax entity holds a participation interest of at least 10 per cent in the foreign company.</p> <p>However, if the foreign equity distribution gives rise to a foreign income tax deduction, then the distribution will not be non-assessable non-exempt income.</p> <p>In this event, foreign equity distribution will be included in the assessable income of the Australian corporate tax entity.</p>	<p>A foreign equity distribution from a foreign company that is received by an Australian corporate tax entity, either directly or indirectly through one or more interposed trusts or partnerships, is non-assessable non-exempt income if the Australian corporate tax entity holds a participation interest of at least 10 per cent in the foreign company.</p>

Detailed explanation of new law

Denial of imputation benefits

3.8 Consistent with the OECD Action 2 Report and the Board of Taxation recommendations, Schedule 2 to this Bill makes amendments to deny imputation benefits on franked distributions made by a corporate tax entity that give rise to a foreign income tax deduction.

3.9 Under the company imputation system, when an Australian corporate tax entity distributes profits to its members, the entity has the option of passing credit for income tax paid by the entity on those profits to those members. This is done by franking the distribution.

3.10 When the Australian corporate tax entity makes a franked distribution, the entity must make a debit to its franking account (section 205-30). The amount of the debit is equal to the amount of the franking credit on the distribution.

3.11 If a member of an entity receives a franked distribution:

- an amount equal to the amount of the franking credit is generally included in the member's assessable income (in addition to the amount of the distribution); and
- the member is generally entitled to a tax offset equal to the amount of the franking credit.

3.12 The amendments operate to deny these imputation benefits if the distribution gives rise to a foreign income tax deduction. *[Schedule 2, items 1 to 3, paragraph 207-145(1)(db), paragraph 207-150(2)(eb) and section 207-158]*

3.13 Subject to transitional rules, these amendments address the announcement in the 2017-18 Budget relating to the application of the OECD Hybrid Mismatch Rules to Regulatory Capital (even though the amendments are not limited to regulatory capital).

Foreign equity distributions assessable

3.14 Consistent with the OECD Action 2 Report and the Board of Taxation recommendations, Schedule 2 to this Exposure Draft Bill makes amendments to ensure that foreign equity distributions that are entitled to a foreign income tax deduction are included in a corporate tax entity's assessable income.

3.15 In this regard, a foreign equity distribution from a foreign company that is received by an Australian corporate tax entity, either directly or indirectly through one or more interposed trusts or partnerships, is non-assessable non-exempt income if the Australian corporate tax entity holds a participation interest of at least 10 per cent in the foreign company (Subdivision 768-A).

3.16 The amendments ensure that, if the foreign equity distribution gives rise to a foreign income tax deduction, then the distribution will not be non-assessable non-exempt income. *[Schedule 2, items 6 to 8, paragraph 768-5(1)(d), paragraph 768-5(2)(f) and subsection 768-7(1)]*

3.17 Consequently, in this event, foreign equity distribution will be included in the assessable income of the Australian corporate tax entity.

3.18 However, these amendments do not apply to a foreign equity distribution if:

- the foreign income tax deduction arises because the company that made the distribution is recognised under a law of a foreign country in which the deduction arises as being used for collective investment; and
- foreign income tax or a withholding-type tax was payable in respect of the distribution.

[Schedule 2, item 8, subsection 768-7(2)]

3.19 The reason for this exception is to ensure consistent treatment for Australian investors into collective investment vehicles that are established under the laws of different countries which may utilise different tax mechanisms for achieving the same overall outcome for the same types of specific investment.

3.20 In addition, the paragraph 768-5(1)(d) is disregarded for the purposes of calculating the attributable income of an eligible controlled foreign corporation if:

- the eligible controlled foreign corporation receives, either directly or indirectly through one or more interposed trusts or partnerships, a foreign equity distribution; and
- at the time the distribution is made, both the eligible controlled foreign corporation and the company are residents of the same listed country or unlisted country.

[Schedule 2, items 4 and 5, subsection 404(2) of the ITAA 1936]

Example 3.1: Deductible foreign equity distributions

Aus Co holds a profit participating loan in Foreign Co. The profit participating loan is treated as:

- an equity interest for Australian income tax purposes under Division 974; and
- an ordinary loan for Country B purposes.

The interest payments on the profit participating loan are foreign income tax deductions and are therefore ineligible for the participation exemption in Australia.

Application and transitional provisions

Denial of imputation benefits

3.21 Subject to transitional rules for regulatory capital of authorised deposit-taking institutions, the amendments to deny imputation benefits apply to distributions made on or after the day that is six months after the day that this Bill receives the Royal Assent. *[Schedule 2, subitem 9(1)]*

3.22 However, transitional rules for regulatory capital apply if:

- before 9 May 2017, either:
 - an authorised deposit-taking institution issued an Additional Tier 1 capital instrument (within the meaning of the prudential standards determined by APRA under

section 11AF of the *Banking Act 1959*, as in force at the time that this Schedule commences);

- a general insurance company issued an Additional Tier 1 capital instrument (within the meaning of the prudential standards determined by APRA under section 32 of the *Insurance Act 1973*, as in force at the time that this Schedule commences); or
- a life insurance company issued an Additional Tier 1 capital instrument (within the meaning of the prudential standards determined by APRA under section 230A of the *Life Insurance Act 1995*, as in force at the time that this Schedule commences); and
- the instrument is callable, and there is a scheduled call date of the instrument on or after 9 May 2017.

[Schedule 2, subitem 10(1)]

3.23 In these circumstances, the amendments do not apply in relation to distributions on the instrument that are made before the first scheduled call date of the instrument that occurs on or after 9 May 2017. *[Schedule 2, subitem 10(2)]*

Foreign equity distributions assessable

3.24 The amendments to make foreign equity distributions assessable apply to foreign equity distributions made on or after the day that is six months after the day that this Bill receives the Royal Assent. *[Schedule 2, subitem 9(2)]*

