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22 December 2017

Implementing the OECD Hybrid Mismatch Rules

Dear Sir/ Madam,

We attach our submission regarding Australia's implementation of the OECD Hybrid Mismatch Rules (**the Rules**) via the exposure draft of *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017: Amendments* (**TLAB**).

We appreciate the opportunity to be involved in the consultation. This is a preliminary and high level submission principally addressing policy issues and we would welcome the opportunity to provide additional feedback to Treasury prior to introduction of the TLAB to Parliament.

Due to the complexity and far-reaching nature of the Rules, we recommend the Government not rush to introduce the TLAB into Parliament. Rather, once this period of consultation is closed the Government should take an appropriate amount of time to review issues identified by stakeholders and amend the TLAB as necessary to ensure the policy objectives of the Rules are achieved without producing inequitable outcomes.

In reviewing the draft Rules, we have identified transitional, policy and technical matters which, in our view, either need to be resolved or clear guidance issued on their application sufficiently in advance of the effective start date of the Rules such that taxpayers are able to make informed decisions and restructure their affairs as necessary with reasonable certainty.

1. Transitional

1.1. Timing

In order to allow more time to consider the development of the Rules and in recognising the complexity of the law and relatively narrow period of time between submissions close and planned law introduction in early February 2018 we understand Treasury is seeking input on an alternative to having the Rules commence six months after Royal Assent (the previously announced effective date). The alternative is that the Rules become effective after a period of time post law introduction rather than 6 months post Royal Assent, with the timing intended to broadly result in the same effective date that would have occurred under the previously announced effective date. By way of example, under the previously announced effective date, the Rules may be introduced in the autumn parliamentary program commencing 5 February 2018 with Royal Assent occurring, say, at the end of March 2018 and commencement of the Rules on or about 1 October 2018. Under the alternative, the Rules may be introduced into Parliament in say late March 2018, with the Rules to become effective six months after this and still therefore or about 1 October 2018 start date.

We would support this alternative as it gives Treasury additional time, potentially two months, to properly consider the Rules and the submissions received.

We also understand Treasury intends to align the effective date of the Rules to the nearest quarter month start. That is, if the effective date is for example in mid-October then the effective date would be 1 October. We generally agree with this approach, however, we note that a safeguard should be introduced to ensure effective date is not merely the earliest quarter date before the existing effective date as this could potentially bring the start date forward by as much as two to three months. For example, a late September effective date in this scenario could be brought forward to the first day of the quarter starting on 1 July 2018 under a worst case example.

1.2. Application of General Anti-Avoidance Regime

In the Board of Taxation's (**BoT**) Report to the Treasurer (*Implementation of the OECD Hybrid Mismatch Rules* March 2016, **the Report**) the Board recognised that the clear intent of the hybrid mismatch rules is to deter taxpayers from using hybrid arrangements to exploit differences in countries tax regimes[1].

In response to the implementation of hybrid mismatch rules into Australia's domestic tax law, the Board expected many affected taxpayers to restructure their existing arrangements[2]. It is therefore important that the Rules are designed to encourage restructuring. Accordingly, EY recommends there should be a specific provision within either Part IVA or the Rules which provides that any restructure undertaken only to be in compliance with the Rules is not subject to Part IVA. We acknowledge that such a provision would need to be narrowly drafted so that only taxpayers entering into restructures with the purpose of complying with the Rules are able to avail themselves of the provision.

We consider that there is an inequity in the law if Treasury does not provide for a part IVA carve out, particularly if a deduction is denied for interest in financing arrangements and the associated debt capital remains in the adjusted average debt (refer to section 3.1 below for further discussion on the thin capitalisation issue). In effect, taxpayers that may otherwise not choose to unwind hybrid structures (for example because of commitments to external financing arrangements and exposure to substantial unwind complications and costs) will effectively be forced to restructure in order to merely maintain thin capitalisation capacity. We think that it would be inappropriate to apply part IVA particularly in circumstances where companies are effectively forced to restructure merely to maintain borrowing capacity.

Furthermore, we see it as an excessive response to restructuring concerns if both part IVA and a specific integrity rule is introduced in response. EY considers that it is critical that taxpayers have certainty on what structures can and cannot be contemplated given the need imposed on taxpayers to restructure and the relatively narrow time period in which to make these restructuring decisions. A general part IVA application in addition to an integrity rule will provide a less certain environment than a specific integrity rule in isolation in which to make these decisions.

EY and other stakeholders have previously submitted that there should be a carve out for part IVA, however if Treasury does not provide a carve out we recommend that the foreshadowed Practical

[1] Paragraph 4.18
[2] Paragraph 4.19

Compliance Guide (**PCG**) part IVA administrative guidance provide the following:

- Detailed examples on the specific structures that the ATO is concerned about and , conversely would not be concerned about, as alternatives to hybrid financing;
- A clear position on whether the ATO agrees with the generally accepted view that the *CPH*[3] case establishes the precedent that part IVA cannot apply to restructures in advance of the law being enacted (as acknowledged by the BoT[4]); and
- That the PCG guidance in this regard should be released as soon as possible to provide taxpayers with a clear understanding of the ATO's position on part IVA application.

2. Policy

2.1. Application to low tax, territorial and repatriation based regimes – hybrid financial instrument mismatch

The financial instruments rule under section 832-490 is not intended to apply in circumstances where one of the reasons for the mismatch is because the lender is in a country where either:

- the lender does not tax the return because the lender's jurisdiction does not have a tax regime (e.g. Cayman Islands); or

- the lender does not tax the return on the instrument because the lender's jurisdiction applies a territorial or repatriation based regime for the taxation of foreign sourced interest income (e.g. Hong Kong/ Singapore/ France).

There are explicit references and examples in the OECD Hybrid Report[5] (**Hybrid Report**) that confirms this. In relation to territorial regimes for example, the OECD says at Paragraph 98:

"A mismatch in tax treatment that arises in respect of a cross-border payment made to a taxpayer in a pure territorial tax regime (i.e. a jurisdiction that excludes or exempts all foreign sources income) will not be caught by the hybrid financial instrument rule because the mismatch in tax outcomes will be attributable to the nature of the payer (i.e. to the fact that payer is a non-resident making payments of foreign sourced income) rather than the terms of the instrument itself."

Examples 1.6 and 1.8 in the Hybrid Report also makes this clear (applicable to no tax and territorial regimes respectively).

We consider that an ordinary reading of section 832-500(1)(b) leads to the same conclusion. However, this could be clearer. We recommend that the law and/or explanatory memorandum include reference to the fact that these circumstances do not result in a hybrid mismatch, ether by way of explanatory memorandum examples or legislative footnote.

It is acknowledged that paragraph 1.99 of the Explanatory Memorandum to the Rules (**EM**) refers to paragraphs 94 to 98 of the Hybrid Report and therefore (by virtue of including 98 dealings with territorial regimes), the EM indirectly clarifies this intention. However, paragraph 1.98 notably does

[3] CPH Property Pty Ltd vs federal Commissioner of Taxation (1988) 88 FCR 21
[4] Paragraph 4.23 Implementation of the OECD Hybrid Mismatch Rules March 2016
[5] Neutralising the Effect of Hybrid Mismatch Arrangements 2015

not address the above circumstances and there are no other references to no tax, territorial or repatriation based regimes in the law or EM to provide certainty on this issue.

2.2. Imported hybrid mismatch rules

In the OECD Hybrid Report[6], the policy intent behind the imported mismatch rule is stated as:

*"to prevent taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore hybrid mismatch into the domestic jurisdiction through the use of a non-hybrid instrument such as an ordinary loan….The key objective of the imported mismatch rule is to maintain the integrity of the other hybrid mismatch rules by removing any incentive for multinational groups to enter into hybrid mismatch arrangements. While these rules involve **an unavoidable degree of co-ordination and complexity,** they only apply to the extent a multinational group generates an intra-group hybrid deduction and will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report".* [Emphasis Added]

The complexity of the imported mismatch rule was also flagged by the BoT in its report at paragraph 3.66:

"In the Board's view, the imported mismatch rule could present considerable compliance challenges for taxpayers and will be difficult for the ATO to administer effectively."

In our view one of the key provisions driving the complexity is the operation of section 832-795. In this regard, subsection 832-795(3) states the following:

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

> *(a) 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*
> *(b) it is sufficient if payments exist between each interposed entity, and each of the payments gives rise to a foreign income tax deduction (but not a *deduction/ non-inclusion mismatch)."*

This when combined with the other provisions giving legal effect to the imported mismatch rules, creates a challenging framework for Australian taxpayers characterised by:

- The rules having potential to apply to a broad range of payments (including royalties, rents and payments for services), not just to interest.
- Australian tax managers and those responsible for tax governance in Australia needing to become knowledgeable not only of Australian tax treatments but also those foreign tax treatment outcomes applicable to transaction counterparties everywhere "up the chain".
- The design features of the definition of "importing payment" contained in section 832-795 create a requirement to identify payment flows through (potentially multiple) chains of related entities and jurisdictions.

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[6] Paragraph 234

- The imported mismatch rules will not apply of the relevant foreign jurisdiction has implemented domestic anti hybrid rules. However, many jurisdictions around the world will not have implemented anti-hybrid rules in the same time frame that the Australian Rules are intending to operate. In particular Under the European ATAD II anti hybrid measures EU member states have agreed a **1 January 2020** start date.

Accordingly, taxpayers are faced with the prospect of having to dissect upstream tax consequences, have deductions denied in Australia and potentially need to restructure in the short term merely because the relevant foreign jurisdiction has not yet implemented its own anti-hybrid rules, despite an intention to do so in the short term.

Due to this complexity of the imported hybrid mismatch rules we recommend:

- The application of the imported hybrid mismatch rules be deferred until:
    - the implementation of the other core Australian hybrid mismatch rules has been in place and tested and their administration settled; and
    - At least the European Union members have fully implemented their substantive anti-hybrid rules (1 January 2020).
- If deferral is not adopted, detailed published guidance will be required on the ATO's administration and the Commissioner's interpretation of the imported mismatch provisions, particularly section 832-795. There are no current examples in the EM explaining the intended operation of the imported hybrid mismatch rules. We would recommend examples be included which clearly articulate the intended application of the rules either or both in the EM and associated guidance material.
- A *de minimis* provision should be considered to address the complexity, potentially aligned to the Diverted Profits Tax (**DPT**) ($25m) *de minimis* Australian turnover test.

2.3. Savings provision – reverse hybrid mismatch

We consider the scope of the reverse hybrid mismatch rules is excessively punitive for those taxpayers who do not use these structures for permanent deferral. A reverse hybrid scenario is distinguishable from the other types of mismatches in the law because a reverse hybrid primarily deals with deferral of tax (that is deferral until such time the reverse hybrid makes a distribution to its owner (s)) whereas the other mismatch rules primarily address permanent deferral.

The problem with the Rules is that the reverse hybrid mismatch rule results in a permanent denial of a deduction to an entity making a payment to a reverse hybrid even where as a matter fact there is no deferral (or permanent mismatch) to the group because the reverse hybrid makes a distribution in the same year (or soon after) the one in which it receives a payment.

We are aware of taxpayers that will use reserve hybrid structures as a tool for managing their tax profile in their home jurisdiction. That is they will use them as a valve to release foreign earnings (and in some cases access underlying (Australian) tax credits) and this will at times involve the reverse hybrid making distributions to the home jurisdiction in the same year or following year that the reverse hybrid receives payments. It is not the case that these structures are necessarily used in practice to achieve long term or even at times any deferral of taxation.

Refer to Example 1.9 in the Explanatory Memorandum (which deals with an Australian entity (Aus Co) making a payment to a reverse hybrid (RHP) that is in turn owned by an investor (Investor Co) in another tax jurisdiction (Country B). If in this example it was instead assumed that RHP made a distribution to Investor Co that is then taxed in Country B and this is made in the same year that the payment was received by RHP from Aus Co then the outcomes under the reverse hybrid rule would be:

- The payment made by Ausco is disallowed for Aus Co
- The distribution received by Investor Co from RHP is taxed
- Economically therefore there is one sided taxation to the group

There is no mechanism contained within the Rules for preserving the deduction which is denied to Aus Co in such a scenario. The problem with the Rules is that the payment to RHP is a different payment than the one being made to Investor Co (the "valve" payment) and therefore the payment to RHP cannot be treated as being *subject to foreign tax* under s832-945 even though economically this payment is subject to tax in Country B.

Accordingly, we recommend a saving provision be introduced into the where the hybrid mismatch is in substance reversed in a reasonable period of time (3 years is suggested as this is consistent with the deferral exception applicable to hybrid financial mismatches under 832-500(2)).

This could be achieved by introducing an exception in section 832-945 that treats an amount of profits as being subject to foreign tax if it is subject to tax *indirectly* through one or more interposed entities within an appropriate time period (3 years as suggested).

2.4. Scope of additional integrity rule

The Honourable Scott Morrison MP in his media release regarding the TLAB, noted:

"Following the introduction of the hybrid mismatch rules, multinational groups investing into Australia may seek to achieve double non-taxation outcomes by using investment structures and arrangements that may not fall within the scope of the OECD's hybrid mismatch rules. For example, foreign headquartered groups investing into Australia may use financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax.

The Government is concerned that such arrangements would undermine the integrity of the hybrid mismatch rules and will therefore be developing a target integrity rule to ensure such arrangements cannot be used to circumvent the hybrid mismatch rules."

In our view, an integrity rule is not required given the existing suite of international integrity rules including transfer pricing, thin capitalisation, DPT and Part IVA. Further, the implementation of such a rule would be out of step with comparable jurisdictions (most notably the UK and New Zealand) which have implemented hybrid mismatch rules without such an integrity measure.

However, if the Government proceeds with this integrity measure, we make the following observations and recommendations:

- We understand from our initial discussions that Treasury intends to apply the law to existing structures regardless of whether the structure has been put in place only to replace an existing hybrid arrangement or is a standalone financing arrangement. EY is concerned that if the Government adopts the latter approach and extends this to all structures then there will be a large number of taxpayers that would have had no warning or reason to anticipate that their existing and potentially long standing financing structures may be caught by such a rule and require restructuring. This is in contrast to hybrid restructures where changes have been foreshadowed (by the OECD BEPS project) for at least 5 years now. Given that restructuring an arrangement is typically a time consuming and costly process requiring substantial planning and lead time, we recommend that:

1. The integrity rule only apply to restructures out of an existing hybrid structure

2. If #1 is not adopted, then existing structures be grandfathered

3. If #2 is not adopted, then a deferred start date for such a measure be introduced (of at least 2 years from Royal Assent) in order to give affected taxpayers appropriate time to restructure their affairs

- The measure be released in exposure draft (**ED**) form and as soon as possible for consultation.

- The release date of the ED be as soon as possible to give taxpayers sufficient time to consider the impact to their affairs as necessary.

- The integrity rule should appropriately recognise the commerciality of financial arrangements. That is, it should not have application purely as a result of tax rates being below a certain threshold. Rather, exemptions similar to those contain in DPT provisions should be considered (i.e. the sufficient tax test, sufficient economic substance test and *de minimis* threshold).

The scope of the "no tax" concept should be carefully considered so as not to encompass structures where the tax result may be a low effective tax outcome because of local incentives, tax credits and Net Operating Loss offsets, territorial/source outcomes, transfer pricing consequences etc. That is, we suggest that if an integrity rule is introduced it should be directed solely at what the international community would consider to be traditional no or low tax jurisdictions (i.e. tax havens) rather than having broader application to non-haven jurisdictions where the effective tax rate may be low because of the factors mentioned above but the headline rate is not. We submit that this latter category is already adequately addressed by the existing DPT framework.

3. Technical Applications

3.1. Thin capitalisation

We highlighted in our earlier submission to the BoT (dated 15 January 2016) the need for appropriate interaction with Australia's thin capitalisation regime is critical in ensuring the Rules do not generate inequitable outcomes.

As no specific provision has been included in the TLAB, an inappropriate thin capitalisation outcome arises where a debt deduction is denied under the hybrid mismatch rules but the debt remains included in "Adjusted Average Debt" for Division 820 purposes.

For Australian thin capitalisation purposes, Adjusted Average Debt in section 820-85(3) (for Outward investing entities (non ADI) comprises in Step 1 of the Method Statement the "…*average value, for that year (the relevant year, of all the *debt capital of the entity that gives rise to *debt deductions for the entity for that or any other income year)*".

A "debt deduction" is defined in section 820-40 and includes interest and amounts in the nature of interest. Under the Rules, the interest amount retains its characterisation as a debt deduction if the borrower can, apart from Division 820, deduct the interest from its assessable income for that year (per paragraph 820-40(1)(b)) or any other year.

Accordingly, if a debt deduction is denied under the Rules, the Debt Capital giving rise to the Debt Deduction will remain included in the calculation of Adjusted Average Debt. This outcome will disadvantage tax payers who otherwise choose to maintain their financing structures despite deductions being denied under the hybrid mismatch rules. Many taxpayers will not wish to undertake a refinancing either at all or in the time frame required to do so before the start date of the Rules because of high unwind costs and commitments to existing external financers for example. These taxpayers should not be penalised by both losing deductions as well as thin capitalisation capacity.

We recommend that Division 820 be amended to address this inappropriate consequence.

3.2. Denial of Imputation Benefits - application to the Regulated Insurance industry

There are a number of ongoing issues concerning the interaction of the Rules to the Regulated Insurance industry. In particular:

- The proposed transitional rules to the denial of imputation benefit provisions under 207-145(1)(da) apply only to Authorised Deposit Taking institutions and not the Regulated Insurance industry despite there being policy arguments that suggest these classes of classes of taxpayer should not be distinguished.

- The introduction of an across the board denial of imputation benefits to taxpayers that obtain a foreign income tax deduction highlights the ongoing issue that section 215-10 provides a carve out from the franking requirement only for Authorised Deposit Taking institutions and not the Regulated Insurance industry and reinforces the case for an extension of 215-10 to this class of taxpayer.

We recommend these issues be given further attention by Treasury and would welcome the opportunity to engage with Treasury on these issues further.

3.3. Dual Inclusion Income

Section 832-1020 contains the definition of dual inclusion income (**DII**).

*"(1) An amount of income or profits of an entity that is a *hybrid payer or *deducting hybrid is dual inclusion income of the entity if 2 or more of the following apply to the amount:*

> *(a) it is *subject to Australian income tax in an income year;*
> *(b) it is* ****subject to foreign income tax*** *in a foreign country in a *foreign tax period;*
> *(c) it is subject to foreign income tax in a foreign country (other than the country mentioned in paragraph (b)) in a foreign tax period."*[Emphasis added]

The meaning of "subject to foreign income tax" is contained within section 832-945.

"(1) An amount of income or profits is subject to foreign income tax in a foreign country in a foreign tax period if:

> *(a) the amount is included in the tax base of a law of the foreign country for the foreign tax period; and*
> *(b) as a result, the amount is taken into account in working out the amount (including a nil amount) of foreign income tax (except credit absorption tax, unitary tax or a withholding-type tax) payable by an entity for the foreign tax period.*

(2) However, an amount of income or profits is not subject to foreign income tax if an entity is ***entitled under the law of the foreign country to a credit****, rebate or other tax concession in respect of the amount for foreign tax (other than a withholding-type tax) payable under a tax law of a different country (including Australia)."* [Emphasis Added]

The carve out under section 832-945(2) where a foreign tax credit is available is inconsistent with the OECD and the BoT recommendations. We recommend that this carve out be removed.

At paragraph 3.54 of the BoT's Report, the Board noted:

"An item of income should be treated as dual inclusion income if it is taken into account as income under the laws of both the payer and payee ***regardless of whether that income is subject to double taxation relief by way of an exemption or credit****."*

The OECD also notes that it should not matter if a foreign tax credit is available[7].

However, the inclusion of this exception in the definition of dual inclusion income produces inequitable outcomes for certain group of taxpayers. We have illustrated the operation of subsection 832-945(2) using two examples contained in the Appendix to this submission. The two examples comprise:

1. A hybrid entity paying operating expenses to an external party resulting in a double deduction outcome (therefore subject to the Deducting Hybrid mismatch rule under 832-L)

2. A hybrid entity making a related party interest payment resulting in a deduction/non inclusion outcome (therefore subject to the Hybrid Payer Mismatch rule in 832-J).

For each example we have contrasted the result that would arise under 4 scenarios:

a) The "**Base Case**" that would result if there was no hybrid at all (which we submit should be the ultimate outcome and measuring stick that should be achieved by the hybrid mismatch rules when applied to a hybrid structure)

b) The outcome with subsection 832-945(2) as drafted (**Current Operation**)

c) The outcome if subsection 832-945(2)was retained but improved with a "gross up" approach (**Modified Operation**)

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[7] Concept also noted at paragraph 126 of the OECD's Report.

d) The outcome if subsection 832-945(2) is removed (**Removal**)

In the examples shown it is clear that the Removal case provides the same after tax result as the Base Case and therefore supports the removal of 832-945(2).

The examples also show that the Current Operation (scenario (b)) provides inequitable outcomes. We understand from our initial discussions with Treasury that it acknowledges that outcome (b) under the law as drafted provides for inequitable results and therefore at a minimum subsection 832-945(2) needs to be either removed or modified. We understand Treasury is considering modifying the rule broadly to "gross up" the Australian tax paid in determining the amount of DII. Under the current draft an amount of income can never be DII even if it carries with it only a low or *de minimis* foreign tax credit and therefore requires modification. We have therefore included scenario (c) to speculate on what such a gross up Modified Operation may look like.

In this respect we can make the following observations on a Modified Operation:

- Grossing up the Australian tax paid to determine the DII can result in the same overall outcome as the Base Case (and Removal case) and therefore is a possible solution.

- However this is a complex issue and it would be necessary to consider as part of the drafting whether the gross up is done using the Australian tax rate or the foreign tax rate (we have included analysis of both in the examples).

- It is apparent that a gross up approach using either the Australian tax rate or Foreign tax rate can provide equitable outcomes provided the foreign tax rate is higher than the Australian tax rate.

- However if the foreign tax rate is lower than the Australian tax rate then grossing up using the foreign tax rate can provide inequitable outcomes by increasing the Australian tax liability over what it should be under the Base case (or Removal) case.

- We appreciate that Treasury has some concerns that allowing income to be DII when attached to foreign tax credits may result in "mischief" where the foreign jurisdiction has excess foreign tax credit/NOL pools. With respect we do not consider that this requires any deliberate policy action to address under the hybrid rules as this is a situation that already applies under the Base case. We would welcome a dialogue with Treasury on this issue where Treasury outlines its concerns in more detail and why it considers a Modified Operation is preferable over Removal .

We consider that the better approach is to remove subsection 832-945(2) entirely for the following reasons:

- Removal provides the same result as the Base Case and therefore there is simply no policy need for 832-945(2) .

- Removal is a better option than the Modified Operation because it eliminates the considerable complexity with the Rules that such an alternative "gross up" approach would involve. This complexity also extends to a need for taxpayers to dissect foreign tax credits and "tag' them to income. This is likely to add significant compliance costs as it will require looking at this issue from the point of view of the foreign tax payer jurisdiction and require, for example, determining the outcomes of Tax Sharing/Funding Agreements in consolidated groups to determine where the foreign tax credits are deemed to reside from the foreign tax jurisdiction point of view. Such a requirement will introduce substantial scope for error and taxpayer confusion.

- Removal is a better option than Modified Operation because the Modified Operation can result in inequitable outcomes as discussed depending on how the gross up is calculated and the relative difference between the Foreign tax rate and Australian tax rate.

- Removal is consistent with the approach of the OECD under action item 2.

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If you have any questions in relation to the above, please contact Andrew Nelson on (08) 9429 2257, Brendan Dardis on (03) 9288 8080 or Tony Stolarek on (30) 8650 7654.

Yours sincerely,
EY

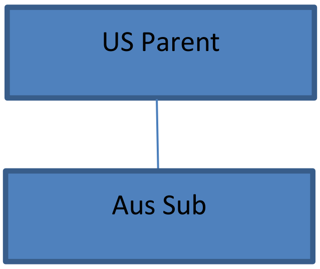
Attachments

Appendix 1 – Dual Inclusion Income: Examples

APPENDIX 1

DII example 1 – Deducting Hybrid Mismatch (832-L)[8]

a. No hybrid case (Base Case)

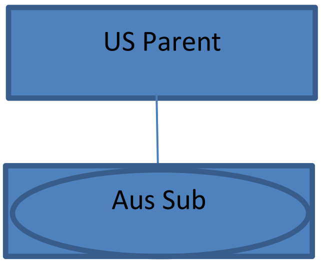


Operating income $100

Operating expenses $80

- Australian subsidiary of US parent (**Aus Sub**)
- Aus Sub is not checked (regarded for US tax purposes)
- Aus Sub derives $100 operating income, incurs $80 operating expenses ($20 taxable income)
- Aus Sub Australian tax = $6 (30% of $20)
- US parent receives dividend distribution of $14
- US parent taxable income in US = $20 (grossed up dividend). US tax on this at 35% = $7, less credit for Australian tax paid ($6) = $1 tax payable in US
- Overall tax (Australian tax plus US tax) to group = <u>$7</u>

b. Hybrid case with subsection 832-945(2) operating as drafted (Current Operation)



Operating income $100

Operating expenses $80

- Aus Sub subsidiary of US parent
- Aus Sub is checked to be disregarded (deducting hybrid mismatch rule therefore applies)
- Aus Sub derives $100 operating income, incurs $80 operating expenses
- Aus Sub is denied the deduction of $80 under the deducting hybrid mismatch rule (i.e there is no DII because the $100 income carries with it foreign (Australian) tax credits)
- Aus Sub tax = $30 (30% of $100)
- US parent sees taxable income of $20 ($100 income less $80 expenses). US tax on this at 35% = $7, less credit for Aus tax paid ($30) = $no tax payable in US but excess foreign tax credits of $23
- Overall tax (Australian tax plus US tax) to group = <u>$30</u>

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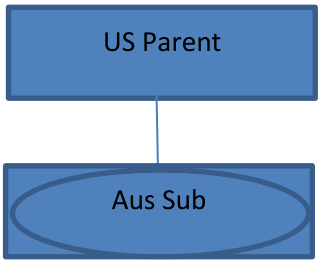
[8] This example applies the US current tax system as one jurisdiction example to explore the foreign tax credit policy issue. The fact that the US system will likely adopt a territorial approach is acknowledged but not relevant to the underlying issue being examined

c. Hybrid case with subsection 832-945(2) modified to remove application to income carrying foreign tax credits (Modified Operation)

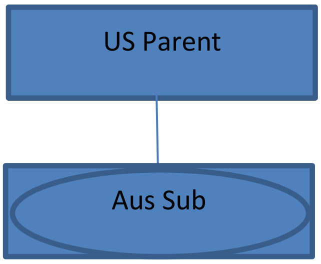


Operating income $100

Operating expenses $80

- Aus Sub subsidiary of US parent
- Aus Sub is checked to be disregarded for US tax purposes (deducting hybrid mismatch rule therefore applies)
- Aus Sub derives $100 operating income, incurs $80 operating expenses
- 832-945(2) is modified to provide that DII is equal to $80 and non DII income is equal to $20[9]
- Aus Sub assessable income = $100
- Aus Sub deduction = $80 (because DII is equal to $80)
- Aus Sub tax = $6 (30% of $20)
- US parent has taxable income of $20 ($100 income less $80 expenses). US tax on this at 35% = $7, less credit for Aus tax paid ($6) = $1 tax
- Overall tax (Australian tax plus US tax) to group = <u>$7 (correct outcome consistent with non-hybrid case</u>)

d. Hybrid case if 832-945(2) is removed (Removed)



Operating income $100

Operating expenses $80

- Aus Sub subsidiary of US parent
- Aus Sub is checked to be disregarded for US tax purposes (deducting hybrid mismatch rule therefore applies)
- Aus Sub derives $100 operating income, incurs $80 operating expenses ($20 taxable income)
- Aus Sub Australian tax = $6 (30% of $20)

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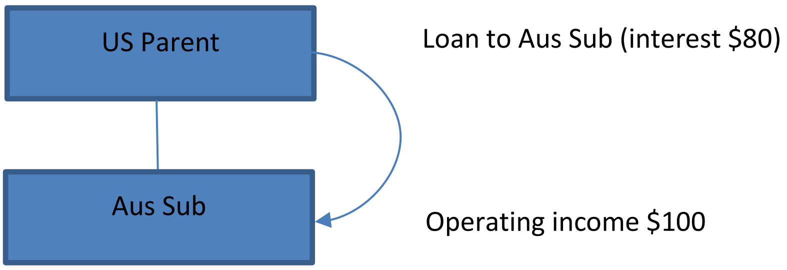
[9] This assumes the income sheltered is grossed up using the Australian tax rate - i.e $6/.30 = $20. It is arguably more appropriate to gross up using the foreign (US rate) or 35% - i.e $6/.35 = $17. This does not impact the example materially here as this would result in DII increasing and be higher than operating expenses of $80. However if the foreign tax rate is lower than the Australian rate then this will result in in equitable outcomes when compared to Base case example (a) as the DII will be less than Aus Sub's expenses (for example if the foreign rate was 21% then the DII would be only $71 (i.e $100 - $6/.21) and the Australian tax paid under c) would equal $9 (30% of taxable income of $29, given $9 of Australian deductions would be denied) and then exceed the base case Australian tax of $6 under a). This therefore results in an inequitable outcome.

- US parent has taxable income of $20 ($100 income less $80 expenses). US tax on this at 35% = $7, less credit for Australian tax paid ($6) = $1 tax
- Overall tax (Australian tax plus US tax) to group = **$7** (correct outcome consistent with non-hybrid case)

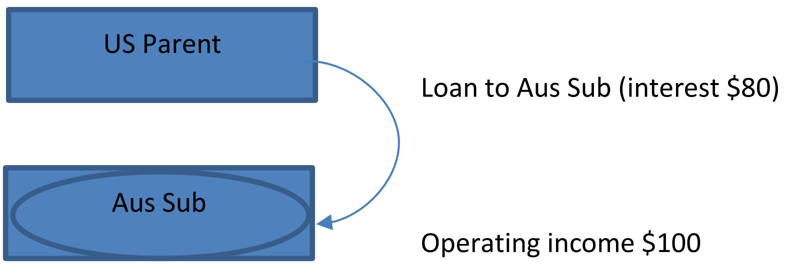
DII example 2 – Hybrid Payer Mismatch (832-J)[10]

a. No hybrid case (Base case)



- Australian subsidiary of US parent (Aus Sub)
- Aus Sub is not checked (regarded for US tax purposes)
- Aus Sub derives $100 operating income
- US parent lends $1,600 to Aus Sub at a 5% interest rate
- Aus Sub incurs $80 interest expense
- Aus Sub taxable income equals $20 (being $100 - $80)
- Aus Sub Australian tax = $6 (30% of $20)
- US parent receives dividend distribution of $14 (being equal to $20 net of $6 Australian tax)
- US parent taxable income in US = $100 ($20 (grossed up dividend) + $80 interest). US tax on this at 35% is $35, less credit for Aus tax paid ($6) = $29 tax payable in US
- Overall (Australian tax plus US tax) tax to group = **$35** (Australia share $6, US share $29)

b. Hybrid case with subsection 832-945(2) operating as drafted (Current Operation)



- Aus Sub is checked (disregarded for US tax purposes)
- Aus Sub derives $100 operating income
- US parent lends $1,600 to Aus Sub at a 5% interest rate
- Aus Sub incurs $80 interest expense (the hybrid payer mismatch rule therefore applies)
- Aus Sub is denied the deduction of $80 under hybrid payer rule (i.e. there is no dual inclusion income because the $100 income carries with it foreign (Australian) tax credits)
- Aus Sub tax = $30 (30% of $100, no deduction for the loan interest)
- US parent sees taxable income of $100. US tax on this at 35% = $35, less credit for Australian tax paid ($30) = $5

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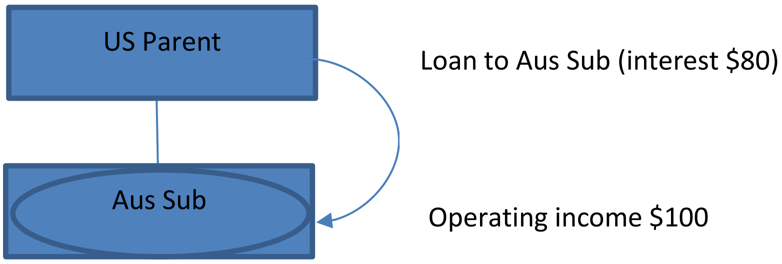
[10] This example applies the US current tax system as one jurisdiction example to explore the foreign tax credit policy issue. The fact that the US system will likely adopt a territorial approach is acknowledged but not relevant to the underlying issue being examined

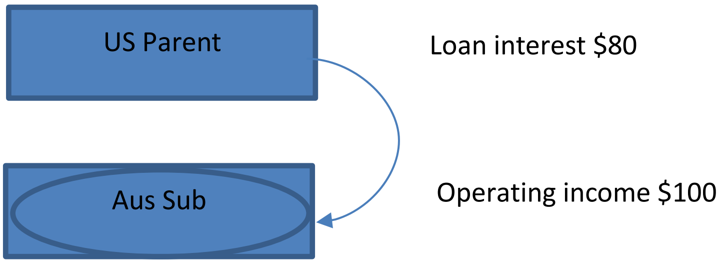
- Overall (Australian tax plus US tax) tax to group = <u>$35 </u>(Australian share $30, US share $5)

c. Hybrid case with subsection 832-945(2) modified to remove application to income carrying foreign tax credits (Modified operation)



- Aus Sub is checked (disregarded for US tax purposes)
- Aus Sub derives $100 operating income
- US parent lends $1,600 to Aus Sub at 5% interest rate
- Aus Sub incurs $80 interest expense (the hybrid payer mismatch rule therefore applies)
- Subsection 832-945(2) is modified to provide that Dual Inclusion Income is equal to $80 and non-Dual Inclusion Income is equal to $20[11]
- Aus Sub assessable income = $100
- Aus Sub deduction = $80 (because Dual Inclusion Income is equal to $80)
- Aus Sub taxable Income = $20
- Aus Sub tax = $6 (30% of $20)
- US parent has taxable income of $100. US tax on this at 35% = $35, less credit for Australian tax paid ($6) = $29
- Overall (Australian tax plus US tax) tax to group = <u>**$35** (Australian share $6, US share $29 - correct outcome consistent with non-hybrid case</u>)

d. Hybrid case if subsection 832-945(2) removed (Removal)



- Aus Sub is checked (disregarded for US tax purposes)

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[11] This assumes the income sheltered is grossed up using the Australian tax rate - i.e $6/.30 = $20. It is arguably more appropriate to gross up using the foreign (US rate) or 35% - i.e $6/.35 = $17. This does not impact the example materially here as this would result in DII increasing and be higher than operating expenses of $80. However if the foreign tax rate is lower than the Australian rate then this will result in in equitable outcomes when compared to Base case example (a) as the DII will be less than Aus Sub's expenses (for example if the foreign rate was 21% then the DII would be only $71 (i.e $100 - $6/.21) and the Australian tax paid under c) would equal $9 (30% of taxable income of $29, given $9 of Australian deductions would be denied) and then exceed the base case Australian tax of $6 under a). This therefore results in an inequitable outcome.

- Aus Sub derives $100 operating income
- US parent lends $1,600 to Aus Sub @5% interest
- Aus Sub incurs $80 interest expense (the hybrid payer mismatch rule therefore applies)
- Aus Sub assessable income = $100
- Aus Sub deduction = $80 (because Dual Inclusion Income is equal to $100)
- Aus Sub taxable Income = $20
- Aus Sub tax = $6 (30% of $20)
- US parent has taxable income of $100. US tax on this @35% = $35, less credit for Australian tax paid ($6) = $29
- Overall (Australian tax plus US tax) tax to group = **$35** (Australian share $6, US share $29 - correct outcome consistent with non-hybrid case)