pwc

The Manager
Base Erosion and Profit Shifting Unit
Corporate Income Tax Division
Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

22 December 2017

By email: BEPS@treasury.gov.au

Dear William,

Implementing the OECD Hybrid Mismatch Rules

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission to Treasury in relation to the Exposure Draft legislation and accompanying Explanatory Memorandum (*Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017: Amendments*) to implement the OECD hybrid mismatch rules, released for comment on 24 November 2017.

We are disappointed by the extremely short time made available to comment on the Exposure Draft legislation and accompanying Explanatory Memorandum (released more than a year and a half after the original Federal Budget announcement) and the lack of time provided for consultation with Treasury on very complex and far-reaching legislation.

Given the complexity of provisions and limited timeframe, the intention of our submission is not to cover detailed technical points but rather to focus on several key issues. We note that we have already discussed a wide range of technical issues with the drafting of the provisions with Treasury.

Executive summary

In our view, there are two fundamental issues that need to be addressed:

1. Start Date. The proposed start date for the entire hybrids package (as announced in the press release dated 24 November 2017) should be reconsidered. Consistent with OECD and Board of Taxation (**Board**) recommendations, the Government committed to ensuring these new rules would apply six months after the relevant Bill received Royal Assent to ensure taxpayers are given sufficient lead time to allow them to assess current arrangements and restructure where necessary. However, the Exposure Draft legislation does not include the critical Targeted Integrity Rule (**TIR**) or the branch mismatch rules and the whole package is required to inform restructuring.

   The start date should be at least six months after the entire package of rules receives Royal Assent.

2. Restructuring. It is critical that the Government provide certainty in relation to the intended restructuring with other integrity measurers and, most particularly, the general anti-avoidance rules in Part IVA (**Part IVA**) which now also include the separate Diverted Profits Tax (**DPT**).

   The Explanatory Memorandum should clearly state that the Government's intention and expectation, in accordance with OECD recommendations, is that existing hybrid arrangements will be restructured to avoid any adverse Australian tax consequences associated with hybridity.

Detailed comments

PwC makes the following general submissions.

1. **Start date for all aspects of the hybrid mismatch rules**

   The Exposure Draft legislation seems intended to apply to relevant payments made six months after the Bill receives Royal Assent. However, the drafting of this important aspect is not clear.

   We understand the Government intends to release separate Exposure Draft legislation for both the branch mismatch rules and TIR (see further below). However, it is apparently intended that these separate measures will commence from the same time as the general hybrid mismatch rules reflected in the Exposure Draft legislation. Unfortunately, it is unclear when this additional Exposure Draft legislation will be released and whether we will have at least six months to consider the entire hybrids package before all rules become operative.

   Treasury are reminded that the OECD recommended in its final report that "the effective date for the hybrid mismatch rules should be set far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse tax consequences associated with hybridity".

   Acknowledging the inherent complexity of the hybrid mismatch rules, the Board were also deliberate in their recommendation regarding the commencement date noting that "taxpayers should be given a minimum period of six months to restructure with final legislation in place (and ideally 12 months with draft legislation)". The Board also "encouraged release of draft legislation in advance of the proposed commencement date to allow time for further consultation on the detailed design of the rules". This also formed the basis of the Government's commitment announced in the 2016 Federal Budget.

   The interests of fairness require that an Exposure Draft of the new law should be available well in advance of the proposed application date and that ample time is provided for public consultation. It is only fair that taxpayers are afforded sufficient time, following release of Exposure Draft legislation encompassing all anticipated measures announced in the press release, to determine the likely impact of these very complex rules and to enable restructuring of existing arrangements to occur.

   For these reasons, PwC strongly recommends the Government consider applying the hybrid mismatch rules from the **later of** 1 January 2019 or six months after the Bill receives Royal Assent. For the avoidance of any doubt, the Bill should include the whole package of hybrid measures. To the extent the latter option prevails, we further recommend that the rules apply from the first day of the relevant quarter - for example, 1 January, 1 April, 1 July or 1 October - to avoid unnecessary reporting complications.

2. Restructuring to remove hybrid mismatch outcomes

Based on very limited information provided in the Treasurer's press release, it seems that the new TIR will be introduced to ensure planning arrangements cannot be used to circumvent the hybrid mismatch rules. The press release outlines the broad intent of the new integrity rule but fails to provide any detail of its scope and application. In MYEFO, the TIR was described as "an integrity provision to ensure that the effect of the hybrid mismatch rules cannot be circumvented by the use of investment structures and arrangements which, for example, include one or more interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax". MYEFO also explained that the TIR and hybrid branch mismatch rules are estimated to have a small unquantifiable gain to revenue over the forward estimates period.

PwC have been advocates for reform of Australia's international tax rules through balanced measures which attract global capital, incentivise growth and disqualify inappropriate advantages in a fair manner. However, we do highlight that the TIR is not a feature of the OECD hybrid mismatch recommendations and therefore represents another example of unilateral action being taken by Australia that is inconsistent with its commitment to ensure consensus based international tax reform.

We understand the current intention is for the relevant Bill to be submitted to Parliament in early February 2018, meaning the operative date could be some time in the second half of 2018. The Government's intention to have the TIR apply from the same time as the hybrid mismatch rules, in light of this rushed timing, is extremely problematic. Taxpayers will have insufficient time to fully consider the impact of the TIR in any plans to restructure to remove hybrid mismatch outcomes in accordance with the policy of the hybrid rules.

In almost all cases, simply allowing the hybrid mismatch rules to apply to existing arrangements will not be a viable option for various reasons (for example, the risk of withholding tax on non-deductible interest, impact on thin capitalisation and transfer pricing). However, the only guidance available to taxpayers now who are looking to replace hybrid arrangements with non-hybrid arrangements (consistent with OECD policy), and avoid the application of the TIR, is one high-level example embedded in the press release which provides clarity on this critical rule. This is not acceptable given the time and cost involved with restructuring.

PwC strongly believes that taxpayers need at least six months with Exposure Draft legislation before the TIR should become operative. Further, the rule should be clearly drafted such that taxpayers will not require ATO clearance in relation to restructuring.

In addition to the TIR, we also observe that the general anti-avoidance rules in Part IVA (which include DPT) will need to be considered by taxpayers forced to restructure by the hybrid mismatch rules.

The Board included in its final report a recommendation that detailed administrative guidance be provided by the Commissioner on whether, and in what circumstances, Part IVA would be applied to restructures undertaken to avoid the application of the hybrid mismatch rules to preserve an existing deduction. The Board further stated that draft administrative guidance should be made available at the same time as Exposure Draft legislation. Unfortunately, one month after release of Exposure Draft legislation, no ATO guidance has been released or even announced.

In addition, we believe it would be far more efficient for the Exposure Draft legislation to deal with this restructuring issue. Given the expectation that the hybrid mismatch rules are predicted not to impact revenue collections, we believe that, as a minimum, the Explanatory Memorandum could state clearly that the Government anticipates and encourages restructuring which removes hybrid mismatch outcomes.

Finally, we highlight that the discussion above is focused on restructuring (that is, steps taken to remove hybrid outcome associated with existing arrangements). Although not clearly stated in the Government announcements, we anticipate that the TIR could also apply to new financing arrangements (that is, to fund an acquisition or other capital requirement) which amplifies the importance of providing certainty to taxpayers.

3. Dual inclusion income rule

The dual inclusion income concept is extremely narrow and requires clarification in a number of areas. We have provided Treasury some examples of common taxpayer scenarios and have discussed some of the key technical issues with the current drafting that require further clarification.

4. Interaction with other operative provisions

We have identified a large number of technical issues with the current drafting of the provisions based on our work with clients. Some of these have already been raised with you during consultation. Given the limited time available, we have not sought to address all interaction and drafting issues in this submission.

However, we do want to reinforce a number of key issues:

- The drafting of the “subject to tax” and “attributable to” hybridity rules require refinement to address the examples discussed with Treasury.
- A specific “foreign exchange” carve out rule is required to ensure that foreign exchange gains and losses remain outside the scope of the hybrid mismatch rules.
- It should be made clear that the hybrid mismatch rules are not intended to be incorporated into the CFC rules (which is similar to the approach taken for TOFA and the debt and equity rules - refer section 382 ITAA 1936).
- We understand that a deliberate policy decision has been made by the Government not to amend the thin capitalisation and withholding tax provisions in circumstances where the hybrid mismatch rules disallow deductions on interest payments made by an Australian entity.

  This produces an extremely harsh result - for example, interest payments that are not deductible (despite complying with debt/equity and transfer pricing rules) will continue to be subject to interest withholding tax and the non-deductible debt will continue to be included as debt for thin capitalisation purposes.

  We note that these extremely harsh outcomes will increase the incentives for taxpayers to restructure as a result of the hybrid mismatch rules.
- It should be made clear section 46FA ITAA 1936 dividends are not intended to be rendered non-deductible by the hybrid mismatch rules.

- Hybrid mismatch transitional relief for AT1 regulatory capital instruments and section 215-10 ITAA 1997 should be extended to regulated general insurers (including authorised non-operating holding companies).

5. Branch mismatch rules

In our view, the timing for introduction of branch mismatch rules (viz at the same time as the hybrid mismatch rules) is too ambitious. There has been over 2.5 years of work and consultation regarding the effects and interaction issues associated with the hybrid mismatch rules (for example, Board implementation review, Treasury consultation etc).

Given the final OECD report on branch mismatch arrangements was not released until July 2017, this same level of work and consultation has not been conducted in relation to this aspect of the hybrid mismatch rules. Branch hybrid mismatch rules need to be carefully considered and consultation undertaken to ensure unintended consequences do not arise. In particular, in will be necessary to consider the interaction of branch hybrid mismatch rules with our policy settings in relation to the foreign branch exemption (for example, what is a branch hybrid mismatch and what is an intended policy outcome of the branch exemption?) and the uncertainties in relation to the attribution of profits to branches (for example what is a branch hybrid mismatch and what is simply a result of international misalignment on the PE attribution rules?).

PwC urges the Government to consider delaying the implementation of these rules until such time that all relevant issues and interactions can be worked through.

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We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions please contact us.

Your sincerely,

Peter Collins	Angela Danieletto	Jayde Thompson
Partner	Partner	Director
International Tax Leader	Global Tax	Global Tax