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4 April 2018

OECD Hybrid Mismatch Rules

Dear Sir/ Madam,

We attach our second submission regarding the implementation of the OECD Hybrid Mismatch Rules (**the Rules**). This submission is in relation to the revised exposure draft of *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017 (***RED Bill**).

We continue to appreciate the opportunity to be involved in the consultation and we have welcomed Treasury's response to the submissions provided in relation to the first version of the exposure draft[1] (**TLAB**). Following the completion of this round of consultation we will welcomely take the opportunity to participate in any further consultation prior to the law being introduced into Parliament.

As out in our first submission on TLAB, due to the complexity and far-reaching nature of the Rules, we continue to recommend that the Government not rush to introduce the law into Parliament. As with TLAB, once this period of consultation is closed the Government should take an appropriate amount of time to review and address issues identified by stakeholders to ensure the policy objective of the Rules are achieved without producing unexpected or unintended outcomes.

Further, the Government should identify and publicise the areas of the Rules for which they intend to issue guidance (e.g. in the forms of Practical Compliance Guides or Law Companion Guides etc) prior to the Application date of the rules. This will ensure taxpayers are able to understand the Government's interpretation of the law and this understanding can inform their decisions in relation to these Rules.

In our first submission we focussed on policy issues arising from the TLAB. However, as we understand the Government's views on the policy intent of the Rules are largely settled we have focused on some technical application aspects of the Rules themselves in this submission. Notwithstanding this, we encourage the Government to reconsider policy positions adopted in relation to, in particular, interaction with the Thin Capitalisation regime and the application date of the Imported Hybrid Mismatch Rules as set out in our first submission.

1. Integrity Rule – Sub-division 832-J

As we have discussed with you we do not consider the current examples are adequate to address the application of the integrity rule to many real world examples faced by company groups. We understand you will be reworking the examples and we welcome this. We consider it is critical that comprehensive examples be provided in order to provide guidance on the application of sub sections 832-800 (5) and (6) n in particular, given these subsections are so broadly drafted. This guidance could come in the form of additional examples in the Explanatory Memorandum to the RED Bill, a Practical Compliance Guide

[1] Consultation closed on 22 December 2017

or both. Due to potential for this Rule to capture a large number of international related party financing arrangements it will be important that taxpayers are provided with clarity regarding its application.

In reworking the examples we recommend that clarity be provided on two key issues:

- When does the scheme referred to in subsection 832-800(5) begin; and
- When is the design intent referred to in subsection 832-800(6) measured?

As such, we have explored two examples below that highlight these issues. We would be pleased to discuss these examples with you further.

Example 1.1 (Example 1.27 from the EM)

While we agree and can see the policy intention that the integrity rule not apply in this example we have trouble applying the framework of the law in the context of this EM example. This is because:

- For the purpose of the scheme in 832-800(5), the last paragraph of the example states that the scheme comprises both the establishment of Regional Hold Co and the funding of Aus Co.
- However, the language of 832-800(6) infers (although not clear) that the time for testing the intent is when the scheme is put in place. This therefore raises the question, in the context of example 1.27, whether the time for testing the design intent is:
    - at the time Regional Hold Co is established?

      In this case it would be difficult to see how the design exemption could ever *not* be met if funding Aus was not anticipated at the time Regional Hold Co was established. This prompts the question whether the exemption still be available if future circumstances were:

      - at the time Aus Co is funded Regional Co funds Aus Co with new equity from Global Co ; or
      - at the time Aus Co is funded Regional Co is not still a Regional holding company

      Arguably the answer is yes, the exemption would be available.

      OR

    - The time for testing design intent is at the time of funding Aus Co?

      This prompts the following questions:

      - If this is the case then is the law to be interpreted that the scheme itself be narrowed to the funding of Aus Co only?

      - If the time for testing is at the time of funding Aus Co then does it matter what the history of Regional Co was – or is it merely relevant what the circumstances are at the time of funding?

- In either case, the example should make it clear whether it is required to consider what the "intent" is at the time of testing. This issue is explored more in the next example.

Example 1.2

- ParentCo is a European listed company with investments (via wholly owned subsidiaries) in many countries throughout the world, including Australia.
- To finance the future expansion of the operations in certain jurisdictions ParentCo sets up a financing company (**FinCo**) in a preferred jurisdiction with a tax rate of less than 10%. FinCo is equity financed and initially has no functional employees other than a local board of directors who have proper authority to exercise their duties has directors.
- AusCo (an Australian tax resident company) is the first subsidiary to receive an interest bearing loan from FinCo.
- At the time of funding it is intended that Fin Co will become a fully functional financing and treasury centre for the ParentCo group of companies, however no plans have yet been implemented in this regard.
- In the income years following FinCo does becomes a financing and treasury hub for the ParentCo group of entities. It has a small number of employees however they have the requisite skills to perform these functions, financial arrangements with external parties and a sufficient balance sheet to bear the risk of the functions it performs. Further, it provides interest bearing financing funding to ParentCo's subsidiaries in jurisdictions other than Australia.

Issue:

The issue that this raises is:

- If it is assumed that the testing time for the purposes of subsection 832-800(6) is at the time of the funding of Aus Co then is the intent to establish a financing/treasury centre to be taken into account (in which case the exemption is available) or is the fact there is no financing/treasury center at the time the determinative factor (in which case the exemption is not available).

  We consider that the appropriate outcome is the former.

Example 1.3

- Assume the facts per example 2, but further assume that at the time Aus Co is funded there was no intention to form a financing/treasury centre in the future (but one nonetheless is after a subsequent change of strategy)

Issue:

The issue that this raises is:

- If in the initial years it is assumed that FinCo was unable to the demonstrate that the arrangements were not a scheme designed to produce the effects in 832-800(5) (that is, the exemption was not available) in initial years, is it nonetheless able to demonstrate the scheme was not designed to produce the effects in 832-800(5) in later income years once the full financing/treasury functionality has been established? (That is, can the exemption ever be obtained, or is the fact that the intent was not there at the outset of the funding the determinative factor).

We consider the appropriate outcome is that the changing circumstances should be able to be taken into account such that the exemption is available once the financing /treasury functionality is established.

2. Employee share scheme recharges

As you will be aware it is common for foreign headquartered multinational listed entities with Australian subsidiaries to:

- Issue parent stock (including options are rights etc..) to employees
- Recharge the cost to the Australian subsidiary to the extent the cost is attributable to employees of the Australian subsidiary (recharge)

Subject to appropriate transfer pricing the recharge will generally be deductible under section 8-1 to the Australian subsidiary on the basis that the costs are an employee related cost of business.

We are concerned that recharges such as this will, in many instances, be caught by the financial instruments mismatch rule. This is because:

- In at least one jurisdiction, the US, the income received from a stock option may not be taxable. For the US at least this is because a US multinational is not able to make a profit from issuing its own stock [2] and a consequence of this is that the income from charging for the stock may not assessable (and the issue of the stock is itself not deductible).

- The financial instrument mismatch rule applies to a debt interest, equity interest or a derivative financial arrangement[3].

- An employee share scheme recharge would not ordinarily be expected to be a debt or equity interest (on the basis that the arrangement is not a "financing arrangement").

- However, the recharge arrangement may qualify as a "derivative financial arrangement"[4]. This is because stock (or options or rights) will often be issued prior to vesting. In the interim period between issue and vesting the "value" of the arrangement will vary (and may be accounted for as such at the Australian subsidiary level) in response to the value of the parent listed shares. This prima facie can result in the arrangement being treated as a derivative financial arrangement given the broad definition of this term.

[2] Under IRC section 1032, a US corporation can not recognise a gain on the issuance of its own stock for cash
[3] ss832-215(1)(a)
[4] Under ss 230-550(1)(a) the definition is broadly drafted to encompass a financial arrangement where its value changes in response to changes in a variable (including a financial instrument price , eg shares)

We recommend that a carve out from the financial instrument rule apply for recharge arrangements for the following reasons:

- There is not any 'mischief" here as the US multinational is neither taxed nor receives a deduction for the stock issued and the overall result is that a deduction is taken in Australia for what is a true cost to the multinational for the issue of stock to employees.

- Australia's transfer pricing rules already act as an appropriate integrity measure to ensure that there is no inappropriate deductions taken in Australia for an employee share scheme recharge.

- Carving out employee share scheme recharge arrangements would avoid what could otherwise be a disruptive and inappropriate outcome impacting a large footprint of multinationals.

This carve out could be structured as a broad carve out from the hybrid financial instrument rule or, alternatively, as a narrower carve out under the "derivative financial arrangement" inclusion to exclude derivative financial arrangements that result from employee share scheme recharge arrangements.

We would be please to provide assistance in structuring carve out if Treasury is amenable to this request.

3. Imported mismatch rule

- We understand that the intention of paragraph 1.279 of the EM is to clarify that where one foreign (Entity 1) in a chain of entities equity funds another foreign entity (Entity 2) then this equity link will break the chain for the purposes of the imported mismatch indirect payment test, such that any hybrid mismatch above Entity 1 will not result in an imported mismatch in relation to an Australian debt financing structure below Entity 2.

  However, we consider that the last line of paragraph 1.279 EM reference does not clearly convey this intention and therefore we recommend this be clarified. We consider that the current reference could be interpreted as meaning that the equity between Entity 1 and Entity 2 is ignored for the purposes of determining whether the indirect payment test is met, rather than resulting in the indirect payment test being failed.

4. Addressing the need for exceptions for widely held CIVs, tax exempt pension funds and SWF entities

We note that the current RED contains no exceptions from the Hybrid Mismatch rules for widely held CIVs, tax exempt pension funds, SWFs and their controlled subsidiaries to recommend that a limited exception be provided for these low risk entities.

We submit that this is necessary in order to bring the Australian Hybrid Mismatch rules into alignment with (i) the OECD BEPS Action 2 Report, (ii) the Board of Taxation recommendations contained in its March 2016 Report into the Implementation of the OECD hybrid mismatch rules and (iii) the UK Anti Hybrid rules.

All of these reports and legislation recognise the desirability of excluding foreign tax exempt entities and collective investment vehicles from the Hybrid Mismatch rules to protect the tax neutrality of and recognise the low risk nature of these entities.

OECD BEPS Action 2 & Board of Taxation Reports

The OECD Action 2 Report considered that certain investment vehicles should be carved out from the hybrid financial instrument rules to protect the tax neutrality of these vehicles. The vehicles referred to in the OECD Report are those collective investment vehicles resident in a jurisdiction that grants the vehicle the right to deduct dividend payments to investors i.e. CIVs such as US Mutual Funds.

Recommendation 9 of The Board of Taxation Report into the Implementation of the OECD hybrid mismatch rules recommended a similar exclusion on the following terms:

> **Recommendation 9**
>
> The Board recommends that further consideration be given during the legislative design process to specific exceptions from the hybrid mismatch rules including, but not limited to:
>
> - The exceptions recommended in the Action 2 Report, consistent with the approach taken under recommendation 1.5 in respect to special investment vehicles, including for securitisation vehicles;
> - Financial traders – repurchase agreements and securities lending agreements; and
> - Managed Investment Trusts (widely held).

In light of the above recommendations, we expect that the absence of no exceptions from the Hybrid Mismatch rules for widely held CIVs, tax exempt foreign pension funds, SWFs and their controlled entities may have been an oversight. This is particularly the case given the excellent work of Treasury and the Government on IMR, AMIT and related reforms which have considerably strengthened Australia's financial sector.

Ideally, the exception would exclude all five types of entity listed in s177J(1)(f) (listed below) from the application of the entirety of the Hybrid Mismatch rules. If this is not possible , we request that the same five types of entity as direct or indirect payees be excluded from the operation of the Hybrid Mismatch rules in a similar manner to the UK model. Finally if this is not possible, we request that at a minimum that the same five types of entity as direct or indirect payees be excluded from the operation of the Subdivision 832-J integrity rules.

We outline below the UK model in relation to exceptions to the Hybrid Mismatch rules, with some comments about a potential Australian drafting approach.

UK MODEL

The UK Anti Hybrid rules take the approach of exempting certain types of low risk widely held taxpayer from the operation of the UK rules.

That UK test provides an exclusion in s.259 CB(9) of the Finance Act 2016 as follows:

> For the purposes of this section disregard—
>
> (a)any excess or part of an excess mentioned in subsection (2), and
>
> (b)any under-taxed amount,
>
> that arises as a result of a payee being a relevant investment fund (see section 259NA).

Relevant investment funds

259NA Meaning of "relevant investment fund"

(1)"Relevant investment fund" means—

(a) an open-ended investment company within the meaning of section 613 of CTA 2010,

(b) an authorised unit trust within the meaning of section 616 of that Act, or

(c) an offshore fund within the meaning of section 354 of this Act (see section 355),

which meets the genuine diversity of ownership condition (whether or not a clearance has been given to that effect).

POTENTIAL AUSTRALIAN DRAFTING APPROACH

If an exclusion from the entirety of the Hybrid Mismatch rules is not possible for these entities, a similar approach to the UK approach could be followed for Australia's Hybrid Mismatch rules, given Australia's bipartisan Government policy intent to develop Australia as a financial centre (a similar direction to that of the UK).

We favour an approach similar to the UK approach, which identifies low risk collective investment vehicles which only in their capacity of being a payee would not be subject to the Hybrid Mismatch rules. This suggested approach is also consistent with the existing exclusion for widely held collective investment vehicles in the DPT.

This drafting approach could include an exclusion for direct or indirect payees that are widely held collective investment vehicles similar to the exclusion from the DPT contained in s 177J(1)(f) :

Exclusions could be added to the draft Hybrid Mismatch rules to cover the same range of entities which are currently excluded from the DPT in s177J(1)(f) being:

(f) the direct or indirect payee is not any of the following:

(i) a managed investment trust (within the meaning of the *Income Tax Assessment Act 1997*);
(ii) an entity covered by paragraph 275-20(4)(f) of that Act (foreign collective investment vehicle with a wide membership);
(iii) an entity covered by paragraph 275-20(4)(h) of that Act (entity owned by foreign government etc.) that is a foreign entity;
(iv) a complying superannuation entity (within the meaning of that Act);
(v) a foreign pension fund (within the meaning of that Act);

If you have any questions in relation to the above, please contact Andrew Nelson on (08) 9429 2257, Liz Cullinan on 03 3865 07938 or Scott Kilner on 02 9248 4596.

Yours sincerely,

EY.