
TREASURY LAWS AMENDMENT (MEASURES FOR CONSULTATION) BILL
2019: HYBRID MISMATCH RULES

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>
ADI	authorised deposit-taking institution
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MEC group	multiple entry consolidated group

Chapter 1

Hybrid mismatch rules

Outline of chapter

1.1 Schedule # to this Exposure Draft Bill amends the hybrid mismatch rules in the ITAA 1997 to:

- clarify that the hybrid mismatch rules apply to MEC groups in the same way as they apply to consolidated groups;
- clarify that, for the purpose of applying the hybrid mismatch rules, foreign income tax does not include foreign municipal or State taxes;
- clarify the application of the hybrid mismatch rules to trusts and partnerships;
- clarify the operation of the dual inclusion income on-payment rule;
- ensure that the hybrid mismatch integrity rule can apply appropriately to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules; and
- ensure that franking benefits are not unduly denied on distributions made on Additional Tier 1 capital instruments in certain circumstances.

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

Context of amendments

1.3 The hybrid mismatch rules are designed to prevent entities that are liable to income tax in Australia from being able to avoid income taxation, or obtain double taxation benefits, by exploiting differences between the tax treatment of entities and instruments across different countries.

1.4 The types of hybrid mismatch arrangements are:

- deduction/non-inclusion mismatches, which occur 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; and

- deduction/deduction mismatches, which occur when an entity receives a deduction in two countries for the same payment.

1.5 A mismatch is covered by the hybrid mismatch rules if it is:

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

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

1.7 A targeted integrity rule applies to 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 in Australia (as an alternative to investing into Australia using hybrid instruments or entities or investing into Australia directly).

1.8 The hybrid mismatch rules were introduced in 2018 and apply to income years starting on or after 1 January 2019.

1.9 These amendments will clarify aspects of the hybrid mismatch rules and improve their operation. The amendments address concerns raised by both the Australian Taxation Office and industry stakeholders following the commencement of the hybrid mismatch rules and will provide greater certainty to affected taxpayers.

Summary of new law

1.10 Schedule # to this Exposure Draft Bill amends the hybrid mismatch rules to:

- clarify that the hybrid mismatch rules apply to MEC groups in the same way as they apply to consolidated groups;
- clarify that, for the purpose of applying the hybrid mismatch rules, foreign income tax does not include foreign municipal or State taxes;
- clarify the application of the hybrid mismatch rules to trusts and partnerships;

- clarify the operation of the dual inclusion income on-payment rule;
- ensure that the hybrid mismatch integrity rule can apply appropriately to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules; and
- ensure that franking benefits are not denied on distributions made on Additional Tier 1 capital instruments in certain circumstances.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
For the purpose of working out whether a reverse hybrid mismatch arises, an entity that is a member of a MEC group will be treated in the same way as an entity that is a member of a consolidated group.	For the purpose of working out whether a reverse hybrid mismatch arises, an entity that is a member of a consolidated group is not treated as a transparent entity in Australia.
For the purpose of applying the hybrid mismatch rules, foreign income tax will not include foreign municipal taxes and State taxes.	There is some uncertainty about whether foreign income tax includes foreign municipal taxes and State taxes.
For the purpose of applying the hybrid mismatch rules, trusts and partnerships will be recognised as entities that: <ul style="list-style-type: none"> • make and receive payments; • hold, acquire or dispose of assets; and • can enter into schemes. If an entity is a trust or a partnership, a reference in the hybrid mismatch rules to an amount being included in assessable income, or being allowable (or not allowable) as a deduction to an entity will be taken to be a reference to an amount that is taken into account in determining the net income of the trust or partnership.	No equivalent.
For the purpose of applying the dual inclusion income on-payment rule, an on-payment amount will be taken	The operation of the dual inclusion income on-payment rule is uncertain where, for example, a payment is

<p>to be subject to Australian income tax or foreign income tax if it is reasonable to conclude that the funding income or profits have been subject to Australian income tax or foreign income tax in the country in which the dual inclusion income group exists (including as a result of a previous application of the rule).</p>	<p>made through multiple members of a dual inclusion income group.</p>
<p>The hybrid mismatch integrity rule will be strengthened to ensure that it can apply to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules.</p>	<p>The hybrid mismatch integrity rule may not apply to some financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules.</p>
<p>If all or part of a distribution made on an Additional Tier 1 capital instrument gives rise to a foreign income tax deduction, franking benefits will be allowed on the distribution if an ADI or insurance company notifies the Commissioner of Taxation that it or any other entity will not claim the foreign income tax deduction.</p>	<p>If all or part of a distribution made on an Additional Tier 1 capital instrument gives rise to a foreign income tax deduction, franking benefits on the distribution are denied.</p>

Detailed explanation of new law

1.11 Schedule # to this Exposure Draft Bill amends the hybrid mismatch rules to:

- clarify that the hybrid mismatch rules apply to MEC groups in the same way as they apply to consolidated groups;
- clarify that, for the purpose of applying the hybrid mismatch rules, foreign income tax does not include foreign municipal or State taxes;
- clarify the application of the hybrid mismatch rules to trusts and partnerships;
- clarify the operation of the dual inclusion income on-payment rule;
- ensure that the hybrid mismatch integrity rule can apply appropriately to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules; and

- ensure that franking benefits are not unduly denied on distributions made on Additional Tier 1 capital instruments in certain circumstances.

Operation of the hybrid mismatch rules for MEC groups

1.12 Under the consolidation regime (Part 3-90), an Australian owned corporate group can be treated as a single entity for income tax purposes by forming a consolidated group (consisting of the Australian head company and its wholly owned subsidiaries).

1.13 A foreign owned corporate group that has Australian resident members (and two or more first tier Australian subsidiaries) can also be treated as a single entity for income tax purposes by forming a MEC group (consisting of the Australian entities in the group). One of the first tier Australian subsidiaries of the group (an eligible tier-1 company) is taken to be the head company of the group.

1.14 The amendments in Part 1 of Schedule # to this Exposure Draft Bill ensure that the hybrid mismatch rules apply to members of MEC groups in the same way that they apply to members of consolidated groups.

1.15 Therefore, for the purpose of working out whether a reverse hybrid mismatch arises, an entity is not a transparent entity in Australia if, so far as is relevant, the entity is a member of a consolidated group or a MEC group. *[Schedule #, item 3, subparagraph 832-410(2)(b)(ii)]*

1.16 Similarly, for the purpose of working out whether a deducting hybrid mismatch arises, an entity can be a deducting hybrid in relation to a payment if, among other things, the entity is a member of a consolidated group or a MEC group. *[Schedule #, item 4, subparagraph 832-550(c)(ii)]*

1.17 Consequential amendments are made to some notes in the hybrid mismatch rules so that they make appropriate references to subsidiary members of consolidated groups or MEC groups. *[Schedule #, items 1 and 2, note after subsection 832-30(2) and note 2 after subsection 832-325(1)]*

Foreign income tax does not include foreign municipal or State taxes

- 1.18 The hybrid mismatch rules apply to a payment only if:
- a deductible payment gives rise to double non-taxation because it is not included in a tax base – that is, a deduction/non-inclusion mismatch arises; or
 - a payment gives rise to two deductions – that is, a deduction/deduction mismatch arises.

1.19 At least one of the components of a deduction/non-inclusion mismatch or a deduction/deduction mismatch is determined by reference as to whether an amount is ‘subject to foreign income tax’.

1.20 Concerns have been raised that there is some uncertainty about whether foreign income tax includes foreign municipal taxes and State taxes. If foreign municipal taxes and State taxes were taken into account in determining whether a payment is ‘subject to foreign income tax’ and gives rise to a deduction/non-inclusion mismatch or a deduction/deduction mismatch, it would be necessary to consider the taxation consequences for a payment at multiple levels of government in a foreign jurisdiction for the purpose of determining whether a hybrid mismatch arises. This would place an unreasonable compliance burden on affected taxpayers.

1.21 To address these concerns, the amendments in Part 2 of Schedule # to this Exposure Draft Bill clarify that, for the purposes of applying the hybrid mismatch rules, foreign income tax does not include:

- municipal tax; and
- in the case of a federal foreign country – a State tax.

[Schedule #, item 13, subsection 832-130(7)]

1.22 This is relevant for the purposes of determining whether:

- a foreign income tax deduction arises in relation to an amount – this is a core concept that affects the operation of all of the hybrid mismatch rules and the hybrid mismatch integrity rule;
- an amount is subject to foreign income tax – this is a core concept that affects the operation of all of the hybrid mismatch rules (other than the imported hybrid mismatch rule) and the hybrid mismatch integrity rule;
- the extended operation of the hybrid financial instrument mismatch rule in relation to concessional foreign taxes applies;
- an entity is a liable entity – this is a core concept that affects the operation of all of the hybrid mismatch rules and the hybrid mismatch integrity rule;
- the hybrid requirement in the branch hybrid mismatch rule is satisfied;
- an entity is a branch hybrid for the purposes of the branch hybrid mismatch rule;
- a country is a secondary response country for the purposes of the deducting hybrid mismatch rule;

- a payment made by an entity is an importing payment in relation to an offshore hybrid mismatch for the purposes of the imported hybrid mismatch rule.

[Schedule #, items 6 to 12 and 14 to 20, sections 832-110, 832-120, 832-130, 832-235, 832-325, 832-480, 832-485, 832-555 and 832-625]

1.23 As a result of these amendments, taxes imposed at the local or State level in a foreign jurisdiction will not have to be taken into account in determining whether a payment gives rise to a deduction/non-inclusion mismatch or a deduction/deduction mismatch.

1.24 Similarly, for the purpose of applying the hybrid mismatch integrity rule, in working out whether foreign income tax has been imposed on the payment in a foreign jurisdiction at a rate of 10 per cent or less, any municipal taxes or State taxes will not be taken into account. However, the imposition of foreign municipal taxes or State taxes on a payment would be factors that are relevant in determining whether it is reasonable to conclude that a principal purpose of the scheme under which the payment was made included enabling the imposition of foreign income tax at a rate of 10 per cent or less.

Application of the hybrid mismatch rules to trusts and partnerships

1.25 The amendments in Part 3 of Schedule # to this Exposure Draft Bill clarify the operation of the hybrid mismatch rules for trusts and partnerships.

1.26 In this regard, for the purposes of applying the hybrid mismatch rules, it may be necessary to identify an entity and determine:

- whether the entity makes a payment to, or receives a payment from, another entity;
- whether an entity holds, acquires, or disposes of an asset, interest or other property; and
- whether an entity enters into or carries out a scheme or a part of a scheme.

1.27 The hybrid mismatch rules then test the consequences that arise from applying the tax laws of different countries to that entity's payments and income or profits.

1.28 Some uncertainty has arisen in applying the hybrid mismatch rules to trusts and partnerships because of:

- the way that the Australian income tax law applies to these entities; and
- the way in which these entities are treated under the income tax law of foreign jurisdictions.

Certain provisions in the income tax law disregarded

1.29 For the purpose of applying the hybrid mismatch rules, certain provisions in the income tax law are disregarded in determining whether an entity makes or receives a payment. The disregarded provisions are:

- 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 #, item 22, subsection 832-30(1)]

1.30 These provisions are also disregarded for the purpose of identifying the income or profits of an entity. *[Schedule #, item 22, subsection 832-30(3)]*

1.31 This outcome is consistent with the outcome that currently arise under section 832-30. However, the existing subsection is being repealed and replaced due to the expansion of its scope to include special rules for trusts and partnerships.

Trusts and partnerships taken to have done certain things

1.32 For the purpose of applying the hybrid mismatch rules to an entity that is a trust or a partnership, the trust or partnership (instead of a trustee or partner) is taken to:

- make or receive a payment;
- hold, acquire or dispose of an asset, interest or other property; and
- enter into or carry out a scheme or a part of a scheme.

[Schedule #, item 22, subsection 832-30(2)]

1.33 The fact that the trust or partnership (instead of a trustee or partner) is taken to have done these things must also be taken into account in identifying the income or profits of the trust or partnership. *[Schedule #, item 22, subsection 832-30(3)]*

1.34 The objective of these amendments is to clarify the operation of the hybrid mismatch rules for trusts and partnerships by recognising a trust or partnership (instead of a trustee or partner) as the entity that does the specified things, having regard to the fact that some foreign laws may

recognise payments between non-legal entities as giving rise to tax consequences.

1.35 A trust that is a public trading trust is effectively treated as if it were a company for tax purposes (Division 6C of Part III of the ITAA 1936). Therefore, amendments will be made to Division 6C to clarify that the hybrid mismatch rules apply to a public trading trust as though it were a company.

Assessable income and deductions of trusts and partnerships

1.36 Under the income tax law that generally applies to trusts (Division 6 of Part III of the ITAA 1936), the trustee must work out the net income of the trust. The net income of the trust is, broadly, the total assessable income of the trust calculated as if the trustee were a taxpayer in respect of that income and an Australian resident, less allowable deductions (with some exceptions).

1.37 Broadly, any beneficiaries who are presently entitled to a share of the income of the trust are taxable on the corresponding proportion of the net income of the trust. The trustee is generally taxed on the balance of net income – broadly:

- the net income which is not assessed to beneficiaries on the basis or presently entitlement; or
- the share of net income attributable to a beneficiary who is under a legal disability.

1.38 Similarly, under the income tax law that applies to partnerships (Division 5 of Part III of the ITAA 1936), the net income of the partnership must be worked out. The net income of the partnership is, broadly, the assessable income of the partnership calculated as if the partnership were a taxpayer and an Australian resident, less allowable deductions (with some exceptions).

1.39 Any partners who are entitled to a share of the net income of the partnership are taxable on that net income.

1.40 Therefore, if the hybrid mismatch rules operate to include an amount in the assessable income of an entity, or make an amount allowable (or not allowable) as a deduction to an entity, the amount is taken to be included, allowable or not allowable (as the case requires) in determining the net income of a trust or a partnership. [*Schedule #, item 22, subsection 832-30(4)*]

Scope of section 832-30 is limited

1.41 Section 832-30 modifies the way that the hybrid mismatch rules apply to trusts and partnerships in the sense that it treats the trust or partnership (instead of a trustee or partner) as doing certain things.

1.42 However, section 832-30 does not affect whether or not an entity is a liable entity (as defined in section 832-325). *[Schedule #, item 22, subsection 832-30(5)]*

1.43 In this regard, under the hybrid mismatch rules, an entity is a liable entity in Australia if income tax is imposed on the entity in respect of all or part of its profits, or in respect of all or part of the profits of another entity (section 832-325). An entity may be a liable entity even if it has no actual liability to pay income tax.

1.44 A trust that is taxed under Division 6 of Part III of the ITAA 1936 is taxed as a flow-through entity. In these circumstances:

- the trustee of the trust (in its capacity as trustee) is a liable entity in respect of the income or profits of the trust because it is liable to tax on the net income of the trust in some circumstances; and
- each beneficiary of the trust is also a liable entity in respect of the income or profits of the trust because they are liable to tax on the net income of the trust in some circumstances.

[Schedule #, item 25, note 3 after subsection 832-325(2)]

1.45 A trust that is an attribution managed investment trust taxed under Division 276 is also taxed as a flow-through entity. Therefore:

- the trustee of the attribution managed investment trust (in its capacity as trustee) is a liable entity in respect of the income or profits of the trust; and
- each member of the attribution managed investment trust who is attributed a share of the income of the trust is also a liable entity in respect of the income or profits of the trust.

1.46 A trust that is a public trading trust taxed under Division 6C of Part III of the ITAA 1936 is not taxed as a flow-through entity – that is, only the trustee of the public trading trust (in its capacity as trustee) is liable to pay income tax in respect of the income or profits of the trust. Consequently, for the purposes of applying the hybrid mismatch rules, the trustee of the public trading trust (in its capacity as trustee) is a liable entity.

1.47 However, if a public trading trust has made a choice to form a consolidated group and be treated like a company and the head company of the consolidated group then, for the purposes of applying the hybrid mismatch rules, the public trading trust (as the head company of the consolidated group) is a liable entity.

1.48 A trust that is a superannuation entity taxed under Division 295 is also not taxed as a flow-through entity – that is, only the trustee of the superannuation entity (in its capacity as trustee) is liable to pay income tax

in respect of the income or profits of the trust. Consequently, for the purposes of applying the hybrid mismatch rules, the trustee of the superannuation entity (in its capacity as a trustee) is a liable entity.

Consequential amendments

1.49 To avoid doubt, the modifications made by section 832-30 only affect the operation of the hybrid mismatch rules. They do not limit, by implication, any other provision in the income tax law. *[Schedule #, item 22, subsection 832-30(6)]*

1.50 In addition, as a consequence of the amendments in section 832-30 to clarify the operation of the hybrid mismatch rules for entities that are trusts and partnerships, minor amendments are made to notes that refer to an entity's payments, income or profits. *[Schedule #, items 23, 24 and 26, notes after subsection 832-320(1), subsection 832-325(1), subsection 832-320(2) and subsection 832-410(1)]*

The dual inclusion income on-payment rule

1.51 Dual inclusion income is income that is taxed in two countries (section 832-680). It can be applied to reduce the neutralising amount for a hybrid payer mismatch or a deducting hybrid mismatch (sections 832-330 and 832-560). It can also give rise to a later year adjustment for a hybrid payer mismatch or a deducting hybrid mismatch (sections 832-335 and 832-565).

1.52 The dual inclusion income on-payment rule (subsections 832-680(4), (5) and (6)) applies if, broadly:

- a payment which forms income or profits of the payee (the on-payment amount) is made within a dual inclusion income group; and
- the payment can be traced or reasonably linked to an amount of income or profits of the payer (the funding income or profits) that have been subject to Australian income tax or subject to foreign income tax (as the case may be).

1.53 If the dual inclusion income on-payment rule applies, the on-payment amount is treated as if it were subject to Australian income tax or subject to foreign income tax (as the case may be) (subsection 832-680(5)).

1.54 Concerns have been raised that the operation of the dual inclusion income on-payment rule is uncertain where, for example, a payment is made through multiple members of a dual inclusion income group.

1.55 To address these concerns, the amendments in Part 4 of Schedule # to this Exposure Draft Bill clarify that an on-payment amount

will be taken to be subject to Australian income tax or foreign income tax (as the case may be) if it is reasonable to conclude that the funding income or profits have been subject to Australian income tax or foreign income tax in the country in which the dual inclusion income group exists (including as a result of a previous application of the rule) for the purposes of applying:

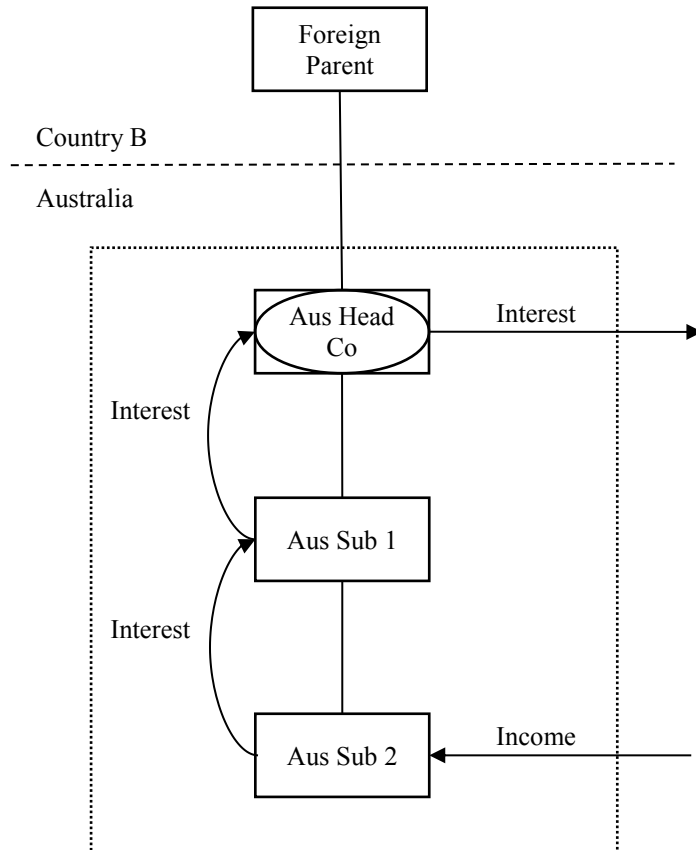
- section 832-680 (which includes the dual inclusion income on-payment rule);
- sections 832-330 and 832-335 (about neutralising amounts and adjustments for hybrid payer mismatches); and
- sections 832-560 and 832-565 (about neutralising amounts and adjustments for deducting hybrid mismatches).

[Schedule #, items 28, 29 and 30, paragraphs 832-680(4)(b), (c) and (d), subsection 832-680(5)]

1.56 Example 1.1 illustrates the iterative operation of the dual inclusion on-payment rule following the amendments.

1.57 Under this example, the on-payment rule is applied to a bottom-up series of payments within a dual inclusion income group. However, in appropriate circumstances, the on-payment rule can equally be applied to a top-down series of payments within a dual inclusion income group.

Example 1.1



Aus Head Co, Aus Sub 1 and Aus Sub 2 are all members of:

- a tax consolidated group in Australia; and
- the same dual inclusion income group in Australia.

Aus Head Co (a deducting hybrid) borrowed an amount from an external bank and makes interest payments to the external bank. The interest payments give rise to deduction/deduction mismatches.

The funds borrowed by Aus Head Co from the external bank were on-lent (via Aus Sub 1) to Aus Sub 2. As a result:

- Aus Sub 2 makes interest payments to Aus Sub 1; and
- Aus Sub 1 makes interest payments to Aus Head Co.

Aus Sub 2 receives external income which is subject to Australian income tax. However:

- Aus Head Co does not receive any income other than the interest payments from Aus Sub 1; and
- Aus Sub 1 does not receive any income other than the interest payments from Aus Sub 2.

The interest payments made between Aus Sub 2, Aus Sub 1 and Aus Head Co are disregarded for Australian income tax purposes (because of the operation of the consolidation single entity rule in subsection 701-1(1)).

However, the interest payments made by Aus Sub 1 to Aus Head Co are subject to foreign income tax in Country B.

Disregarding the dual inclusion income on-payment rule, the interest payments made by Aus Sub 1 to Aus Head Co are not dual inclusion income. This is because, although these interest payments are subject to foreign income tax in Country B, they are disregarded for Australian income tax purposes.

However, the interest payments made by Aus Sub 1 to Aus Head Co may be treated as if they were subject to Australian income tax under the dual inclusion income on-payment rule.

In this regard, the outcome which is taken to have arisen for the on-payment amount under new subsection 832-680(5) is taken to have arisen for the purposes of section 832-680. As a result:

- subsection 832-680(4) can first be applied to the interest payments made by Aus Sub 2 to Aus Sub 1; and
- subsection 832-680(4) can next be applied to interest payments made by Aus Sub 1 to Aus Head Co.

If the interest payments made by Aus Sub 2 to Aus Sub 1 satisfy subsection 832-680(4), the interest income received by Aus Sub 1 from Aus Sub 2 is treated as if it was subject to Australian income tax under subsection 832-680(5). Subsection 832-680(4) can then be applied to the interest payments made by Aus Sub 1 to Aus Head Co.

The interest payments made by Aus Sub 1 to Aus Head Co will ultimately be treated as if they were subject to Australian income tax if it is reasonable to conclude that:

- the interest payments made by Aus Sub 2 to Aus Sub 1 were funded by external income received by Aus Sub 2 (under the first application of subsection 832-680(4)); and
- the interest payments made by Aus Sub 1 to Aus Head Co were funded by interest income received by Aus Sub 1 from Aus Sub 2 (under the second application of subsection 832-680(4)).

Improve the operation of the hybrid mismatch integrity rule

1.58 The targeted hybrid mismatch integrity rule operates to disallow an Australian income tax deduction of an entity for a payment of interest (or a payment of a similar character), or an amount under a derivative financial arrangement, under a scheme to a foreign entity if, among other things, the scheme results in foreign income tax being imposed on the payment at a rate of 10 per cent or less.

1.59 The integrity rule does not apply if, among other things, the payment gives rise to a hybrid mismatch under one of the specific hybrid mismatch rules.

1.60 The amendments in Part 5 of Schedule # to this Exposure Draft Bill ensure that the hybrid mismatch integrity rule can apply appropriately to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules.

Both the deducting hybrid mismatch rule and the integrity rule can apply to a payment

1.61 The integrity rule does not apply to financing arrangements that, for example, give rise to both:

- a deduction/deduction outcome that gives rise to a deducting hybrid mismatch; and
- an effective replication of a deduction/non-inclusion outcome by the interposition of a foreign entity located in a no or low tax jurisdiction.

1.62 The deduction/deduction outcome may trigger the deducting hybrid mismatch rule. However, the entitlement to a deduction may not be neutralised because, for example, Australia is the secondary response country or the deduction has been sheltered by dual inclusion income.

1.63 In these circumstances, the integrity rule does not apply to neutralise the replicated deduction/non-inclusion outcome even though the entitlement to a deduction has survived.

1.64 Therefore, to address these concerns, the integrity rule is being modified so that it can apply to a payment even if the payment gives rise to a deducting hybrid mismatch. *[Schedule #, item 38, subsection 832-725(6)]*

1.65 However, the hybrid financial instrument mismatch will continue to take precedence over the integrity rule. Therefore, the integrity rule will not apply to deny a deduction for a payment to the extent that the deduction is denied under subsection 830-530(2) because the payment gives rise to a deducting hybrid mismatch. *[Schedule #, item 39, subsection 832-725(7)]*

1.66 Minor technical amendments are also being made to the integrity rule to:

- update the guide material for the integrity rule; and
- clarify that the entity that may be entitled to a deduction in respect of a payment (but for the operation of the integrity rule) may not be the paying entity.

[Schedule #, items 34, 35, 36 and 37, section 832-720, paragraph 832-725(1)(e) and subsection 832-725(3)]

1.67 Generally, if a deduction for a payment is denied under the deducting hybrid mismatch rule in an income year, a deduction may be allowed for the payment in a later income year if an amount of dual inclusion income that has been subject to Australian income tax or foreign income tax or is available to be applied by the deducting hybrid in that later income year (section 832-565).

1.68 To protect the integrity of the hybrid mismatch rules, this later year deduction will not be allowed if a deduction would have been denied in the earlier income year under the integrity rule (on the assumption that the integrity rule applied to the payment in that earlier income year).

[Schedule #, item 33, subsection 832-565(2A)]

1.69 This reflects the outcome that would arise if the integrity rule (rather than the deducting hybrid mismatch rule) had applied in the earlier income year. That is, if the integrity rule applies to deny a deduction for a payment in an income year, a deduction is not allowed in a later income year where there is an amount of dual inclusion income in that later income year.

1.70 Examples 1.2 and 1.3 illustrate the operation of new subsection 832-565(2A).

Example 1.2

In the 2020-21 income year, Aus Co:

- makes an interest payment of \$10,000 to Interposed Foreign Co; and
- derives an amount dual inclusion income of \$2,000 – that is, an amount that is less than the interest payment.

Interposed Foreign Co is a resident of a foreign country that has a corporate tax rate of 8 per cent. Both Aus Co and Interposed Foreign Co are members of the Global Co corporate group.

The interest payment made by Aus Co to Interposed Foreign Co gives rise to a deducting hybrid mismatch under section 832-545.

Australia is identified as the primary response country with respect to the deducting hybrid mismatch under section 832-555.

As the deducting hybrid mismatch rule takes priority over the integrity rule, that rule operates in the first instance to deny a deduction for the interest payment under section 832-530 in the 2020-21 income year.

However, dual inclusion income derived by Aus Co (\$2,000) is available to reduce the neutralising amount of \$10,000. Therefore, only \$8,000 of the deduction is disallowed under the deducting hybrid mismatch rule. As a result, a remaining part of the deduction for the interest payment (\$2,000) is still available.

However, subsection 832-725(7) allows the integrity rule to apply to the interest payment to deny that part of the deduction for the interest payment that was not denied under the deducting hybrid mismatch rule.

As the conditions for applying the integrity rule in subsection 832-725(1) are satisfied in relation to the interest payment (and none of the exceptions in subsections 832-725(4) to (6) apply), subsection 832-725(3) will apply to deny the remaining part of the deduction (\$2,000) for the interest payment.

In the 2022-23 income year, Aus Co identifies an additional amount of dual inclusion income (\$8,000) that is available to be applied by the deducting hybrid. However, if the earlier year application of the deducting hybrid mismatch rule to disallow a part of the deduction in the 2020-21 income year is disregarded, the integrity rule would have applied to deny a deduction (assuming the principal purpose test in paragraph 832-725(1)(h) is satisfied) for the whole amount of the interest payment in that income year.

Therefore, subsection 832-565(2A) prevents Aus Co from being able to claim a deduction under subsection 832-565(2) for the interest payment in the 2022-23 income year.

Example 1.3

The facts are the same as Example 1.2 except that:

- in the 2020-21 income year, Australia is identified as the secondary response country with respect to the deducting hybrid mismatch under section 832-555; and
- the relevant primary response country has foreign hybrid mismatch rules.

As a result, the additional requirements in section 832-535 for a secondary response are not met and section 832-530 does not apply to disallow any deduction for the interest payment that gives rise to a deducting hybrid mismatch.

However, subsection 832-725(7) allows the integrity rule to apply to the interest payment to deny a deduction for the interest payment that was not denied under section 832-530 – that is, \$10,000.

The conditions for applying the integrity rule in subsection 832-725(1) are satisfied (assuming the principal purpose test in paragraph 832-725(1)(h) is satisfied) in relation to the interest payment (and none of the exceptions in subsections 832-725(4) to (6) apply).

Therefore, as subsection 832-530(2) has not applied to deny a deduction for the interest payment to any extent, subsection 832-725(3) will apply to deny the entire deduction for the interest payment.

Adjustment under the hybrid financial instrument mismatch rule where a payment is taxed in a later income year may be denied

1.71 If a payment gives rise to a hybrid financial instrument mismatch in an income year, a deduction may be denied in that income year for the deduction component of the mismatch (section 832-180).

1.72 As the payment gave rise to a hybrid financial instrument mismatch in that income year, the integrity rule does not apply in that income year (subsection 832-725(6)), even though the conditions to apply the integrity rule (as set out in subsection 832-725(2)) would be satisfied in relation to that payment. That is, the hybrid financial instrument mismatch takes precedence over the integrity rule.

1.73 If some or all of the payment is subject to foreign income tax or Australian income tax in a later income year, then the hybrid financial instrument mismatch rules apply to allow a deduction for the taxed amount of the payment in the later income year (section 832-240).

1.74 To protect the integrity of the hybrid mismatch rules, this later year deduction will not be allowed if a deduction would have been denied in the earlier income year under the integrity rule (on the assumption that the integrity rule applied to the payment in that earlier income year).

[Schedule #, item 32, subsection 832-240(2A)]

1.75 This reflects the outcome that would arise if the integrity rule (rather than the hybrid financial instrument mismatch rule) had applied in the earlier income year. That is, if the integrity rule applies to deny a deduction for a payment in an income year and some or all of the payment is subject to foreign income tax or Australian income tax in a later income year, a deduction is not allowed for the payment in that later income year.

1.76 Example 1.4 illustrates the operation of new subsection 832-240(2A).

Example 1.4

At the start of the 2020-21 income year, Aus Co enters into a 5 year interest bearing loan, borrowing from Interposed Foreign Co. Under the terms of the loan arrangement, Aus Co is required to make a lump sum payment for the accrued interest at the end of the arrangement.

Interposed Foreign Co is a resident of a foreign country that has a corporate tax rate of 8 per cent. Both Aus Co and Interposed Foreign Co are members of the Global Co corporate group.

The interest bearing loan is a Division 230 financial arrangement for Australian income tax purposes. Aus Co is entitled to a deduction in respect of accrued interest under the loan for the 2020-21 income year due to sufficiently certain (and fixed and determinable) financial benefits (being the interest payment made by Aus Co) to be provided on maturity under the terms of the loan arrangement.

For purposes of applying the hybrid mismatch rules, the accrued interest is a payment made by Aus Co to Interposed Foreign Co and gives rise to a hybrid financial instrument mismatch.

A deduction/non-inclusion mismatch arises because:

- Aus Co is entitled to a deduction in respect of the interest payment on an accruals basis (under the taxation of financial arrangements regime) in the 2020-21 income year; and
- the interest payment will not be subject to foreign income tax in a foreign tax period ending within 12 months after the end of the 2020-21 income year – that is, under the law of the foreign country in which Interposed Foreign Co is a resident, Interposed Foreign Co is taxed only when the cash payment is received in 2024-25 income year (when the lump sum payment is made at the end of the loan arrangement).

Consequently, sections 832-180 and 230-522 apply so that Aus Co is not entitled to a deduction for the payment (being a taxation of financial arrangements loss) in the 2020-21 income year.

In the 2024-25 income year, the cash payment of the interest is subject to foreign income tax in the foreign country in which Interposed Foreign Co is a resident.

Under the current law, section 832-240 would apply to allow a deduction to Aus Co for the payment in the 2024-25 income year.

However, if the payment had not given rise to a hybrid financial instrument mismatch in the 2020-21 income year, the conditions for applying the integrity rule in subsection 832-725(1) would have been satisfied (assuming the principal purpose test in paragraph 832-725(1)(h) is satisfied) in relation to the interest payment (and none of the exceptions in subsections 832-725(4) to (6) would have applied). Therefore, the integrity rule would have applied to deny a deduction for the payment in the 2020-21 income year.

Consequently, subsection 832-240(2A) prevents Aus Co from being able to claim a deduction under subsection 832-240(2) for the whole amount of the interest payment in the 2024-25 income year.

Franking benefits on distributions made on Additional Tier 1 capital instruments issued in Australia

1.77 Additional Tier 1 capital can be issued by ADIs and insurance companies and other entities that are grouped for prudential purposes. If an ADI or insurance company (or other grouped entity) that has a foreign branch issues Additional Tier 1 capital, part of the Additional Tier 1 capital may be attributable to the foreign branch (depending on the laws of the particular foreign country) because the relevant entity is carrying on business in the foreign country where the branch is located (whether or not the Additional Tier 1 capital is issued in Australia).

1.78 An issue has arisen with the operation of the hybrid mismatch rules because all or part of the distribution on Additional Tier 1 capital issued by an Australian entity that is attributed to a foreign branch located in some foreign jurisdictions may be deductible in one or more of those foreign jurisdictions.

1.79 In this regard, currently the hybrid mismatch rules operate to deny imputation benefits on a distribution if all or part of the distribution gives rise to a foreign income tax deduction (paragraph 207-145(da), paragraph 207-150(1)(eb) and section 207-158). An amount that reflects all or part of the distribution will give rise to a foreign income tax deduction if an entity is entitled to deduct the amount in working out the tax base for a foreign tax period under the law of a foreign country dealing with foreign income tax (section 830-120).

1.80 The amount of the deduction entitlement in the foreign country for a distribution on the Additional Tier 1 capital instrument issued by an Australian ADI or insurance company may be for a comparatively small part of the distribution. However, regardless of how small the foreign income tax deduction is compared to the amount of the distribution, this will result in the denial of franking benefits on the whole distribution to investors in the Additional Tier 1 capital instrument. This would have a significant impact on the pricing of Additional Tier 1 capital instruments in Australia.

1.81 Therefore, the amendments in Part 6 of Schedule # to this Exposure Draft Bill ensure that franking benefits are not denied on distributions made in respect of a non-share equity interest if:

- the interest forms part of the Additional Tier 1 capital of an ADI, general insurance company or life insurance company for the purposes of the applicable prudential standards – this reflects the fact that the interest may be issued by an entity (other than the ADI, general insurance company or life insurance company) that is part of a controlled group for prudential purposes; and

- the ADI, general insurance company or life insurance company notifies the Commissioner of Taxation that it or any other entity will not claim any amount of a foreign income tax deduction to which distributions on the interest give rise.

[Schedule #, item 41, paragraph 207-158(1)(b) and subsection 207-158(2)]

1.82 The notification to the Commissioner is irrevocable and must be made in the approved form on or before:

- the day by which the distribution statement is required to be given by the ADI, general insurance company or life insurance company for the first frankable distribution made in respect of the non-share equity interest; or
- a later day allowed by the Commissioner.

[Schedule #, item 41, subsections 207-158(4) and (5)]

1.83 As a transitional rule, in determining whether a distribution is the first frankable distribution in respect of a non-share equity interest, regard should only be given to distributions made on or after the day of Royal Assent to this Exposure Draft Bill. *[Schedule #, item 42]*

1.84 However, if the transitional rule for regulatory capital issued before 9 May 2017 in item 10 of Schedule 2 to *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018* applies in relation to the non-share equity interest, in determining whether a distribution is the first frankable distribution in respect of the interest, regard should only be given to distributions made on or after the later of:

- the first scheduled call date referred to in that item for the Additional Tier 1 capital instrument; and
- the day of Royal Assent to this Exposure Draft Bill.

[Schedule #, item 42]

Application and transitional provisions

1.85 The amendments to ensure that franking benefits are not unduly denied on distributions made on Additional Tier 1 capital instruments in certain circumstances commence on the day that the relevant Act receives the Royal Assent.

1.86 The remaining amendments commence on the first 1 January, 1 April, 1 July or 1 October to occur after the day that the relevant Act receives the Royal Assent.

1.87 The following amendments clarify the operation of the hybrid mismatch rules and ensure that they operate as intended:

- the amendments to clarify that the hybrid mismatch rules apply to MEC groups in the same way as they apply to consolidated groups;
- the amendments to clarify that, for the purpose of applying the hybrid mismatch rules, foreign income tax does not include foreign municipal or State taxes;
- the amendments to clarify the application of the hybrid mismatch rules to trusts and partnerships; and
- the amendments to clarify the operation of the dual inclusion income on-payment rule.

1.88 Therefore, these amendments apply to assessments made for income years starting on or after 1 January 2019 – that is, from the time that the hybrid mismatch rules started to apply. *[Schedule #, items 5, 21, 27 and 31]*

1.89 These amendments are beneficial to affected taxpayers as they will improve the operation of the hybrid mismatch rules by making the rules more certain and removing some anomalous outcomes that arise under the existing law.

1.90 The amendments to ensure that the hybrid mismatch integrity rule can apply appropriately to financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules could disadvantage some taxpayers and therefore apply to assessments made for income years starting on or after 2 April 2019 – that is, to income years starting after the date of announcement. *[Schedule #, item 40]*

1.91 In this regard, these amendments will ensure that the hybrid mismatch integrity rule applies as intended. The primary objective of the integrity rule is to prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups by using interposed conduit type entities that pay effectively no tax to invest in Australia, as an alternative to investing into Australia using hybrid instruments or entities.

1.92 The amendments to ensure that franking benefits are not unduly denied on distributions made on Additional Tier 1 capital instruments in certain circumstances apply to distributions made on or after 1 January 2019. *[Schedule #, item 43]*

1.93 These amendments are beneficial to affected taxpayers as they will ensure that investors in the Additional Tier 1 capital instruments receive franking benefits on distributions where the relevant ADI, general insurance company or life insurance company makes an irrevocable notification that it or any other entity will not claim any amount of a

foreign income tax deduction to which distributions on the interest give rise.