Deloitte.

Deloitte Tax Services Pty Ltd
ACN 092 223 240
550 Bourke Street
Melbourne, VIC, 3000
Australia

Phone: +61 3 9671 7000
www.deloitte.com.au

24 January 2020

Manager
Corporate and International Tax Division
Revenue Group
Treasury
Langton Cres
Parkes ACT 2600

Attention: William Potts

By email: william.potts@treasury.gov.au

Dear William

Exposure Draft: Tax Integrity – Clarifying the Operation of the Hybrid Mismatch Rules

Deloitte appreciates the opportunity to make this submission on the Exposure Draft (**ED**), '*Treasury Laws Amendment (Measures for Consultation) Bill 2019: hybrid mismatch rules'* and related explanatory materials and to consult on these complex and challenging new areas of tax law. We are supportive of clarifications made to the operation of the hybrid mismatch rules[1] that provide more certainty for taxpayers who are impacted by these rules.

Overall, we are of the view that the ED legislation effectively addresses the clarifications highlighted in the 2019-20 Federal Budget and concerns outlined in the Explanatory Materials. However, as outlined in the Appendix, we perceive there to be a number of issues relating to the practical operation of the hybrid mismatch rules associated with the topics highlighted by the ED legislative amendments which are unresolved and which we submit should be addressed as part of the introduced Bill. In particular, we submit:

1. The amended subsection 832-130(7) should not apply for the purposes of section 832-725 (the **integrity rule**).
2. The 'dual inclusion income group' (**DII group**) concept in section 832-680(6) should be amended to clarify that entities which have common collective liable entities can be members of the same DII group, and therefore access the 'on-payments rule' in subsection 832-680(4), as amended by the proposed ED legislation.
3. The restriction on dual inclusion income contained in subsection 832-680(2) should be amended so that Australian taxpayers that invest in collective investment vehicles are not subject to unintended and inequitable consequences by virtue of the deducting hybrid rule.

The attached **Appendix** provides detailed comments in relation to each of these submissions.

---

[1] Division 832 *Income Tax Assessment Act 1997* (**ITAA 1997**).

Delo tte refers to one or more of Deloitte Touche Tohmatsu Lim ted ("DTTL"), ts global network of member firms, and their related entities. DTTL (also referred to as "Delo tte Global") and each of ts member firms and their affiliated entities are legally separate and independent entities. DTTL does not prov de serv ces to clients. Please see www.deloitte.com/about to learn more.

Delo tte is a leading global prov der of aud t and assurance, consulting, financial advisory, risk advisory, tax and related services. Our network of member firms in more than 150 countries and terr tories serves four out of five Fortune Global 500®companies. Learn how Delo tte's approximately 286,000 people make an impact that matters at www.deloitte.com.

Liability lim ted by a scheme approved under Profess onal Standards Legislat on.

Member of Delo tte Asia Pacific Limited and the Deloitte Network.

PUBLIC

Deloitte.

We would be pleased to discuss this with you further as the ED develops. Please feel free to contact me on (03) 8486 1118 or Peter Radlovacki on (02) 8260 4243 or Manu Sriskantharajah on (03) 9671 7310 if you have any questions.

Yours sincerely

Amelia Teng
Partner

Manu Sriskantharajah
Partner

Peter Radlovacki
Partner

Deloitte Tax Services Pty Ltd

PUBLIC

APPENDIX

1 State and municipal foreign taxes

The following section of our submission relates to the proposed amendment to subsection 832-130(7).

As noted in the ED Explanatory Materials this amendment is relevant for the purposes of determining whether an amount is subject to foreign income tax, which affects the operation of the hybrid mismatch integrity rule[2]. Specifically, the relevance is in determining not only whether a payment is or is not subject to foreign income tax, but in determining the relevant rate of tax for the purposes of paragraph 832-725(1)(g)(i).

We acknowledge the concerns that have been cited in relation to the uncertainty and associated compliance burden of measuring state or municipal level taxes in working out whether a payment gives rise to a deduction/non-inclusion or deduction/deduction mismatch. However, we submit that these concerns are not relevant in respect of the hybrid mismatch integrity rule when it comes to working out the relevant rate of tax, on the basis that this aspect of the integrity rule necessitates a quantitative analysis as compared to the binary nature of the D/NI or D/D mismatch. That is, the amount of the state or municipal tax imposed is a relevant factor in whether the integrity rule applies, not whether a state or municipality imposes income tax. Given that the policy objective of the hybrid mismatch integrity rule is to prevent the effective replication of the 'core' hybrid mismatch rules[3], we believe that the amendment in section 832-130(7) should not apply for the purposes of section 832-725. If the ED legislation is enacted as is, with a retrospective application date, taxpayers who have taken positions in relation to interest payments under certain arrangements (for income years ended or ending in calendar year 2020) may be adversely impacted by either a higher compliance burden, as they will be required to analyse and document the arrangement considering all the conditions and potential exceptions to the integrity rule, or by denial of deductions.

An example of such arrangements is where finance has been provided to an Australian borrower by a related party via its Swiss branch. We understand that federal income tax is payable in Switzerland at a rate of 8.5% and that cantonal income tax also applies so the combined effective income tax rate typically is between 12% and 24% for companies subject to ordinary taxation. Some taxpayers have taken positions in relation to the income year ended 31 December 2019 based on a view that both the federal income tax and the cantonal income tax would be considered in determining whether the payment is subject to foreign income tax at a rate of 10% or less for the purposes of paragraph 832-725(1)(g). The ED legislation would deny this position as only the 8.5% federal income tax can be taken into account as a consequence of the amended section 832-130(7). This creates uncertainty for such taxpayers who must analyse how the other conditions of the integrity rule apply to the arrangement, including the principal purpose test in subsection 832-725(1)(h) in relation to income years that have potentially already ended.

In our view, if an overall effective tax rate of more than 10% is evidenced, combining state and federal taxes, there is no effective duplication of a D/NI mismatch or D/D mismatch, given it would result in at least some amount of additional tax being paid in the foreign country (taking into account any potential credit for withholding tax), which would seem to align with the original intent of the integrity rule.

If, contrary to our submission, the ED amendments are to apply for the purposes of the integrity rule, we submit that it should be made clearer that taxes imposed by a country at a federal or state level be treated as a positive factor in disproving whether the principal purpose test is satisfied for the purposes of paragraph 832-725(1)(h). We acknowledge that the Explanatory Material to the ED in paragraph 1.24 provides recognition that the principal purpose test should have regard to the imposition of state taxes and

[2] Paragraph 1.22
[3] Explanatory Memorandum, *Treasury Laws Amendment (Tax Integrity and other Measures No 2) Act* 2019, paragraph 1.351

submit that an additional comment should be included in the Explanatory Materials to support that it is a factor that positively demonstrates that there is no effective replication of a D/NI mismatch.

2 Entities and dual inclusion income

The following section of our submission relates to the proposed amendments to sections 832-30 and 832-680.

The amendments to section 832-30 provide positive clarification in respect of the treatment of payments made by trusts and partnerships for the purposes of applying the deducting hybrid rule. Similarly, the amendments to section 832-680 provide positive clarification for taxpayers seeking to apply the dual inclusion "on-payments rule" in a practical context through a series of payments. However, the implication of section 832-30, as currently drafted, to effectively identify income and profits of an entity on a stand-alone basis leaves unresolved issues in relation the determination of dual inclusion income for taxpayers where the 'parent entity' of the group is a non-corporate collective investment vehicle (i.e. the taxpayer is not wholly owned by a single 'liable entity').

These issues are particularly acute in relation to the deducting hybrid mismatch rule contained in Subdivision 832-G.

Broadly, the deducting hybrid mismatch rule can apply to deny deductions where:

- A payment gives rise to a deduction and a "foreign income tax deduction", thereby giving rise to a "deduction/deduction mismatch";
- There is a "liable entity" in relation to the payment that is the "deducting hybrid";
- The deduction/deduction mismatch exceeds the amount of "dual inclusion income" which the entity is eligible to apply; and
- If Australia is the secondary response country, the scope requirement[4] is met.

Common examples of deducting hybrids include outbound investments in trusts and partnerships which are treated as liable entities in a foreign country and inbound investments into Australian companies and corporate limited partnerships that are 'checked open' (treated as "flow through") for US tax purposes. Such arrangements are typical in private equity investment, managed fund investment, property fund investment and investments by superannuation funds across a range of industries.

We submit that there are two broad areas relating to deducting hybrids and dual inclusion income requiring attention which could be addressed by further incorporation into the ED.

2.1 Issue 1 – Collective investment vehicles and dual inclusion income grouping

Where a deducting hybrid is held by a collective investment vehicle, payments made by the entity arguably give rise to a deduction/deduction mismatch on the basis that they flow through to the ultimate investors in the determination of a share of net income. As hybrid entities, income and profits also flow through to the ultimate investors. However, in some circumstances the income is potentially prevented from being treated as 'dual inclusion income' because of the stand-alone identification of items of income under section 832-20 and a restrictive interpretation of a DII group.

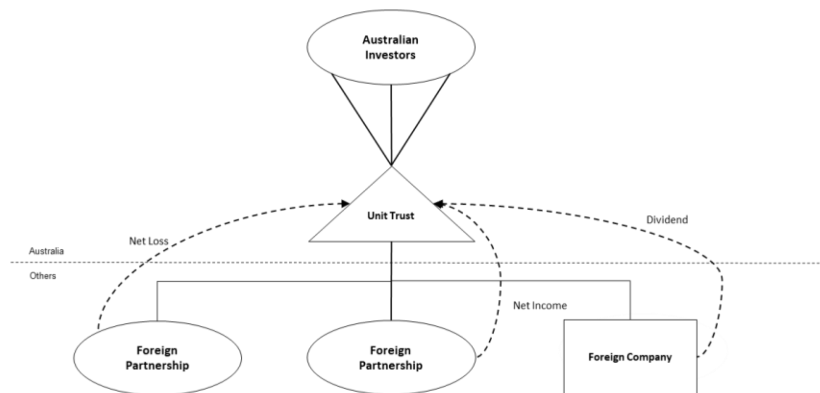
2.1.1 Illustrative examples

Example 1 – Outbound investment by Australian trust

One example where this issue arises is where an Australian taxpayer invests into a collective investment vehicle that is established as a unit trust. Consider that the unit trust invests in foreign partnerships as well as foreign companies which variously give rise to net income or a net loss. Pursuant to subsection 832-110(4) the unit trust is taken to have made a payment that gives rise to a deduction/deduction mismatch

[4] The deducting hybrid and each liable entity in respect of the deducting hybrid's income are members of a Division 832 control group or the payment is made under a structured arrangement.

in respect of the partnership that gives rise to a net loss. The net income distributed from the foreign partnership should be capable of being treated as dual inclusion income under subsection 832-680(1) (to the extent the partnership income is subject to tax in the foreign country). However, the dividend income derived from the foreign company investment would not, prima facie, be considered dual inclusion income under subsection 832-680(1). Therefore, the issue becomes whether the unit trust can rely on the 'on-payments' rule in amended subsection 832-680(4) to effectively trace through to the underlying income of the foreign company. Subject to the facts and whether it is reasonable to conclude that the dividend payment was funded by an amount of income of the foreign company, the on-payments rule could enable the unit trust to recognise the income as subject to foreign income tax, and therefore dual inclusion income, which is the appropriate outcome in the circumstances since all the income and losses are taken into account in determining the net income of the unit trust which is distributed to the investors.



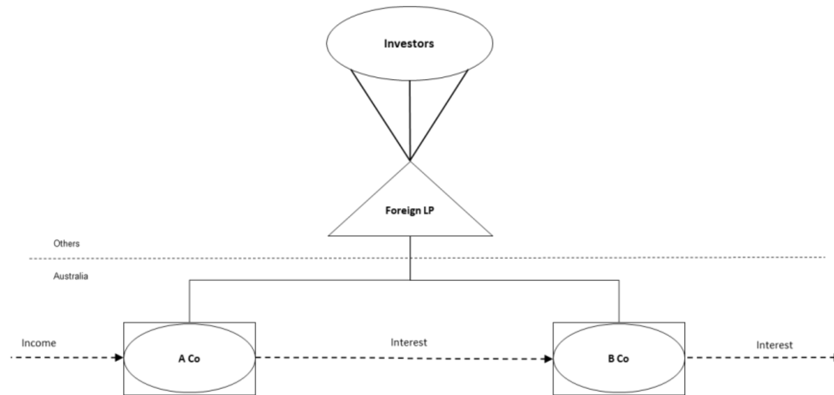
Example 2 – Inbound investor with financing entity

Similarly, inbound collective investment funds can sometimes bifurcate their financing arms from the asset holding investment entities. This is commonly done to provide appropriate separation between the asset vehicle and the finance vehicle for debt security purposes. This bifurcation is usually consolidated at the collective investment fund level for foreign tax purposes so that all that the ultimate investors have regard to is the external income and the external expenses.

For example, consider a collective investment vehicle that is established as a foreign limited partnership which invests into an asset holding company (A Co) and a financing company (B Co). Investors treat the limited partnership as transparent and treat all the entities below the limited partnership as disregarded entities for US tax purposes.

In this case, the deductible payments made by A Co are not deduction/deduction mismatches because the limited partnership does not recognise the payments as foreign income tax deductions. However, the income derived by A Co is prima facie dual inclusion income under subsection 832-680(1). The situation is reversed for B Co – its payments are deduction/deduction mismatches because the limited partners collectively are entitled to a foreign income tax deduction by virtue of the payments being taken into account in the determination of the net income. However, on a stand-alone basis, as required by section 832-30, the payment received from A Co is not prima facie dual inclusion income.

PUBLIC

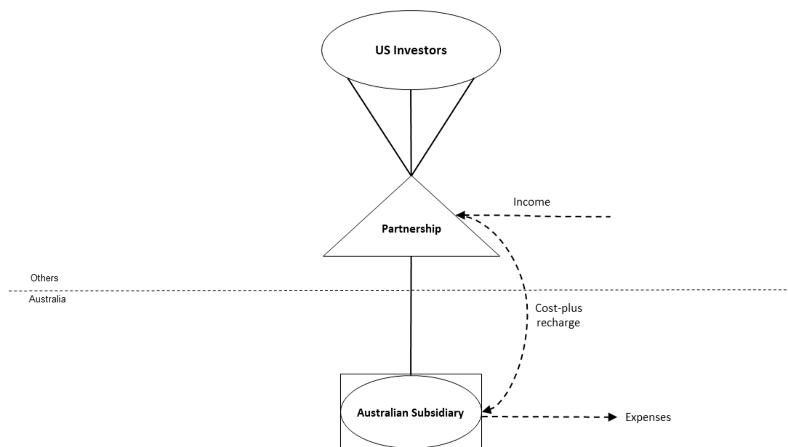


Example 3 – Inbound investor with cost recharge

A third example which is common in the context of service entities. Consider an Australian subsidiary of a US group which is ultimately parented by a non-corporate collective investment vehicle established as a partnership. Where the Australian subsidiary is 'checked open', it will prima facie be a deducting hybrid and deductible payments made by it are likely to give rise to deduction/deduction mismatches on the basis (as above) that the ultimate investors are entitled to deduct their share of the payment by virtue of the partnership's net income calculation.

Where services are performed by the Australian subsidiary for the purpose of the US group deriving external income and the costs incurred by the Australian subsidiary are recharged to the partnership on a cost-plus basis, the net income of the partnership will only have regard to the external expenses and the external income. Accordingly, the Australian subsidiary would prima facie not have an amount of dual inclusion income under subsection 832-680(1).

Therefore, as above, the issue becomes whether the Australian subsidiary can rely on the 'on-payments' rule in amended subsection 832-680(4) to effectively trace through to the underlying income of the foreign partnership.



2.1.2 On-payments rule and DII group

As illustrated above, the on-payments rule contained in subsection 832-680(4) and subsection 832-680(5) is necessary in a number of different inbound and outbound arrangements to achieve an equitable outcome in relation to deducting hybrid mismatches to ensure that economic double taxation does not arise.

However, one of the conditions for the on-payments rule to apply (not amended by the ED) is that the entities are members of the same DII group under subsection 832-680(6).

Subsection 832-680(6) provides:

> *"Two or more entities are members of a group (a dual inclusion income group) in a country for the purposes of this Division if in that country:*
>
> *a) the entity that is a *liable entity in respect of the income or profits of each of the entities is the same entity; and*
>
> *b) no other entity is a liable entity in respect of the income or profits of any of the entities."*

The Explanatory Memorandum that accompanied the Bill that introduced Division 832 (EM) does not provide material guidance in relation to the above tests, stating that:

> *"two entities are members of a dual inclusion income group in a country if in that country:*
>
> - *the entity that is a liable entity in respect of the income or profits of each of the entities is the same entity; and*
> - *no other entity is a liable entity in respect of the income or profits of any of the entities;"*

Pursuant to subsection 832-325(2), an entity is a "liable entity" in a foreign country in respect of the income or profits of another entity where:

> *"*foreign income tax (except *credit absorption tax, *unitary tax or a withholding-type tax) is imposed under the law of the foreign country on the entity in respect of all or part of the income or profits of the test entity for a *foreign tax period."*

Note 2 to subsection 832-325(2) states:

> *"An example is a test entity that is a partnership. In Australia, each partner in the partnership is a liable entity in respect of the income or profits of the partnership."*

In the context of the illustrative examples outlined above, we believe that the appropriate interpretation of subsection 832-680(6) is one under which a DII group exists between entities that are commonly owned by the same collective group of liable entities (i.e. the partners or beneficiaries as the case may be). In particular, taking each of the tests in subsection 832-680(6) in turn:

- *"the entity that is a *liable entity in respect of the income or profits of each of the entities is the same entity": We believe the appropriate interpretation of the relevant provisions is that each partner or beneficiary is a 'liable entity' in respect of that partner's/beneficiary's <u>share</u> of the income or profits of the relevant entities.*

- *"no other entity is a liable entity in respect of the income or profits of any of the entities": Based on the above interpretation, it can be concluded that no other entity is a liable entity in respect of "the income or profits", being that partner's <u>share</u> of the income or profits of the relevant entity.*

Under this interpretation, the deducting hybrid in each scenario would be entitled to the benefit of the on-payments rule. In particular, it is appropriate to construe the reference to "income or profits" in subsection 832-680(6) as a reference to a particular investor's share of income or profits as set out above. However, we recognise that an alternative view may apply that subsection 832-680(6) can only apply to treat a

single liable entity and its wholly-owned subsidiaries as members of a DII group. Applying this interpretation, the examples above are unable to access the on-payments rule and economic double taxation could ensue as a result.

We believe that this alternative interpretation does not achieve the purpose or object of the ITAA 1997 as amended to include the hybrid mismatch rules in Division 832. The purpose and object of the hybrid mismatch rules in Division 832 of the ITAA 1997 is stated in the EM as being:

> *"1.1 … to implement part of the OECD hybrid mismatch rules by preventing entities that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries." (Emphasis added.)*

The EM does not suggest that any purpose or object of Division 832 was to give rise to double taxation outcomes, whether as a matter of Australian or foreign income tax laws or a combination of them.

Nor is any purpose or object of imposing double taxation suggested by the OECD Action 2 Report, which the EM indicates is relevant in interpreting Division 832:

> *"1.19 The hybrid mismatch rules are contained in Division 832. In applying the provisions in Division 832, where appropriate, regard should be had to the commentary in the OECD Action 2 Report and the OECD Branch Mismatch Arrangements Report."*

Rather, like the EM, the OECD Action 2 Report stated the purpose and object of the hybrid mismatch rules as being to prevent double non-taxation:

> *"Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness."*

The OECD Action 2 Report indicated that the concept of "dual inclusion income" was not intended to exclude income treated as non-taxable by one jurisdiction under a domestic dividend exemption, and did not expressly require for this purpose that the payor and payee be members of a group that is wholly-owned by a single liable entity:

> *"126. Double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee jurisdiction should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction. Thus, while a payment of dual inclusion income will generally be recognised as ordinary income under the laws of both jurisdictions, an equity return should still qualify as dual inclusion income if the payment is subject to an exemption, exclusion, credit of other type of double taxation relief in the payer or payee jurisdiction that relieves the payment from economic double taxation.*
>
> …
>
> *In determining whether to treat an item of income, which benefits from such double-taxation relief, as dual-inclusion income, countries should seek to strike a balance between rules that minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers from entering into structures that undermine the integrity of the rules."*

Example 7.1, which considered an intragroup interest payment, confirmed that the above principle was not intended to be limited to dividends:

"Although this interest payment is not taxable under Country A law (because it would be a payment made between members of a consolidated group) it would meet the definition of dual inclusion income because, in this case, the effect of consolidation is to relieve the payee from the economic double taxation on the same income."

We submit that the outcome under consolidation noted above is effectively the same as the outcome in the respect of investors' share of income in the examples illustrated above.

For completeness we note that we are aware of restructure methods which could be entered into to mitigate the risk of the hybrid rules in these circumstances, some of which the Commissioner recognises as low risk from a Part IVA perspective in Practical Compliance Guideline 2018/7 (e.g. removal of hybrid entity by election – Example 5). However, the Australian tax outcome does not change under any of these replacement arrangements and restructuring would be an unnecessary cost and disruption to business models that does not advance the policy of the hybrid mismatch rules.

2.1.3 Proposed solution

Considering the examples illustrated above, we submit that subsection 832-680(6) be amended to clarify that a DII group is able to exist to the extent there are multiple liable entities in respect of the collective pool of income and profits of an entity. This would enable groups which have non-corporate collective investment vehicles as effective parent entities to access the on-payments rule as amended by the ED.

We would be happy to discuss the examples in the context of potential legislative clarification through the consultation process.

2.2 Issue 2 – FITO restriction on DII

As outlined above, Australian investors can be brought into the deducting hybrid rule in a range of circumstance. Without a scope limitation, the deducting hybrid rule means that investors with minority and portfolio holdings in foreign partnerships and trusts are potentially subject to the hybrid mismatch rules.

Aside from the heightened compliance burden for affected taxpayers, there is also what appears to be an unintended consequence as a result of subsection 832-680(2) in its application to collective investment vehicle structures.

2.2.1 Illustrative example – Outbound real estate investment

For example, consider an Australian unit trust investing directly in real property in New Zealand. The Australian unit trust is subject to tax in New Zealand at 28% and is a deducting hybrid because it is a liable entity in New Zealand. Assume the trust has prima facie dual inclusion income and deduction/deduction mismatches. Subsection 832-680(2) requires the unit trust to reduce its DII by applying the following:

*(a) an amount of assessable income of an entity (the assessable amount) would, apart from this subsection, be *subject to Australian income tax; and*

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

then:

*(c) if the amount of the tax offset equals or exceeds the amount of *tax that would, having regard only to the assessable amount and the rate at which tax is imposed on the entity, be payable on the assessable amount - the assessable amount is treated as if it were not subject to Australian income tax; and*

(d) if the amount of the tax offset is a proportion of the amount of that tax - then that proportion of the assessable amount is treated as if it were not subject to Australian income tax.

However, in the context of a unit trust that is a deducting hybrid, it is unclear how much of the foreign tax paid in respect of the underlying investments will count towards a foreign income tax offset, since this is an entitlement of the investors, and is subject to any FITO cap that might apply at the investor level. Furthermore, it is not possible for the unit trust to have regard to the 'rate of tax imposed on the entity' for the purposes of paragraph 832-680(2)(c), because this is an attribute known only to the investor.

This information asymmetry is not only a compliance difficulty but can also lead to double taxation if the unit trust is denied a deduction (due to the reduction in DII) and the investors are not able to offset the increased net income distribution with the FITO. This can arise for example because:

- the investors in the unit trust are subject to different rates of tax, with the Australian tax payable for some (but not all) investors being less than the FITO.
- the increased net income distribution of the trust (due to the reduction in DII) is shared between all investors based on the proportion of the income of the trust estate to which each investor is presently entitled[5].

In this situation the investors that have sufficient Australian tax payable to utilise the FITOs in full are potentially subject to additional tax solely due to the other investors being subject to a lower rate of tax. The investors on the lower rate of tax are also able to access excess FITOs in this case (on the basis that not all of the reduction in DII is allocated to these investors). In contrast, if the higher tax rate investor was the only investor in the Australian unit trust, or if the higher rate investor invested in the asset directly, the increased net income distribution would not apply. These investor level outcomes are not able to be determined at the point in time when present entitlement arises and as such presents an administrative challenge for the custodian.

2.2.2 Proposed solution

Subsection 832-680(2) should not apply to deducting hybrids which are transparent for Australian tax purposes and that are widely held collective investment vehicles, including:

- a listed trust,
- a public unit trust under section 102P,
- a managed investment trust under section 275-10,
- a trust that is a subsidiary of one or more of the above.

While such an exclusion would not address the issue in all cases, it is considered particularly important to exclude the operation of subsection 832-680(2) for widely held collective investment vehicles as it is inherently more difficult (or impossible) to identify the tax rate and availability of FITOs of investors.

[5] Under section 95 and section 97 of the *Income Tax Assessment Act 1936*

PUBLIC