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24 January 2020

Tax Integrity – Clarifying the Operation of the Hybrid Mismatch Rules

Dear Mr Potts

We provide our submission regarding the proposed changes to clarify the operation of the hybrid mismatch rules as contained within the exposure draft of *Treasury Laws Amendment (Measures For Consultation) Bill 2019: Hybrid Mismatch Rules (***the Bill***).*

We have welcomed the opportunity to actively participate in the consultation on the implementation of the hybrid mismatch rules and would be happy to discuss our submission with you in further detail. Specifically, in the attached Appendices our submission covers:

- Appendix 1 – The definition of *Foreign Income Tax*: State and Municipal Taxes
- Appendix 2 – *Liable Entity* definition: Application to Trusts
- Appendix 3 – *Subject to Australian Tax* definition: Application to Trusts

If you have any questions in relation to the above, please contact Andrew Nelson on (08) 9429 2257, James Tomlinson on (02) 9248 4794 or Matthew McCormack on (03) 9288 8234.

Yours sincerely

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Enclosed:

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APPENDIX 1

The Definition of Foreign Income Tax: State and Municipal Taxes

Whilst the Bill contains a number of technical amendments to clarify the operation of the hybrid mismatch rules, this component of our submission is focused on the amendment to *"clarify that, for the purpose of applying the hybrid mismatch rules, the definition of 'foreign income tax' does not include foreign municipal or State taxes"* contained within Part 2 of the Bill.

For the reasons discussed below, we are concerned that the proposed change could result in both inconsistent and inappropriate outcomes for taxpayers who pay interest to certain jurisdictions where that interest is subject to tax at a rate of greater than 10%, as well as create significant additional uncertainty for certain taxpayers, when seeking to apply the integrity rule contained with Subdivision 832-J of the Income Tax Assessment Act 1997 (**ITAA97**).

We have sought to set out below our concerns, as well as our recommendations for how these concerns could be resolved.

1. Background to the proposed law change

Part 2 of the Bill proposes to amend the various sections of Division 832 of the ITAA97 where a reference to "foreign income tax" is made by omitting the existing exceptions to the term "foreign income tax" (being credit absorption tax, unitary tax and withholding-type tax) and adding a single exception for taxes covered (the proposed section 832-130(7) of the ITAA97).

The proposed section 832-130(7) of the ITAA97 replicates the former exceptions to credit absorption tax, unitary tax and withholding-type tax, as well as adding two additional foreign taxes which are to be disregarded for the purposes of Division 832 of the ITAA97, being municipal tax and State tax (in the case of a federal foreign country).

As stated in the draft explanatory memorandum (**EM**) to the Bill, at least one of the components of a deduction/non-inclusion mismatch or a deduction/deduction mismatch is determined by reference to whether an amount is "subject to foreign income tax". Further, the integrity rule can apply to a payment of interest where the highest rate at which that payment is subject to "foreign income tax" is 10% or less.

It is in this context that the definition of "foreign income tax", as contained within section 832-130 of the ITAA97, is key to determining the application of Australia's hybrid mismatch rules (including the integrity rule) to arrangements entered into by Australian taxpayers.

2. Issues identified

Given the importance of the definition of "foreign income tax" to determining the application of Division 832 of the ITAA97, we understand, and appreciate, Treasury's efforts to seek to clarify the definition.

However, in our view, the proposed change to the definition in its current form will both create inconsistent and inappropriate outcomes for taxpayers who pay interest to certain jurisdictions, as well as potentially create significant uncertainty for certain taxpayers when applying the "principle purpose test", when considering the application of the integrity rule.

In our view, the proposed change to the definition of "foreign income tax" for the purposes of the integrity rule contained within Subdivision 832-J of the ITAA97 is inappropriate for the following reasons:

- Excluding foreign State and municipal taxes from the definition of "foreign income tax" for the purposes of determining whether payments of interest are subject to tax at a rate of greater than 10% in the foreign jurisdiction when applying the integrity rule (section 832-725(g) of the ITAA97) can lead to differing outcomes for taxpayers who pay interest to an entity resident in a jurisdiction which administers its income tax at a Federal, State and/or municipal level, as opposed to a jurisdiction that levies income tax only at a Federal level, even where that interest income is subject to income tax at an equal, or higher, rate in the first mentioned jurisdiction.
- In substance this will effectively treat certain jurisdictions, notably Switzerland, as "havens" for the purposes of the integrity rule, when such jurisdictions are not engaging in harmful tax practices or otherwise recognised as havens in the international tax community. This will create unfair and distorted outcomes that divert financing away from, we submit, jurisdictions that should have no policy concerns as financing locations.
- Whilst the EM states at paragraph 1.24 that State and municipal taxes are able to be taken into account in determining whether it is reasonable to conclude that a principle purpose of the scheme included enabling the imposition of foreign income tax at a rate of 10% or less on a payment, on a strict reading of the legislation following the proposed amendments, in our view such State and municipal taxes should not be capable of being taken into account when making an assessment under the "principle purpose test" contained within section 832-725(h) of the ITAA97, creating significant uncertainty for taxpayers.

We have expanded on these concerns further below.

Concerns arise in relation to the integrity rule only

We acknowledge the potential concern that having certain State taxes (in particular, US State taxes) included in the definition of "foreign income tax" for the purposes of Division 832 of the ITAA97 may compromise the "deducting hybrid" and "hybrid payer" mismatch rules where certain hybrid arrangements (for example check the box planning) do not give rise to a deduction/non-inclusion outcome as a result of being subject to a State tax whilst still economically achieving a deduction/non-inclusion outcome for Federal taxes.

We wish to clarify that our concerns in relation to the proposed change to the definition of "foreign income tax" for the purposes of Division 832 of the ITAA97 is limited to the operation of the integrity rule contained within Subdivision 832-J of the ITAA97 only. We accept that there is a need for State and municipal taxes to be excluded from the definition of foreign income tax for the other subdivisions of Division 832 of the ITAA97 which, unlike Subdivision 832-J of the ITAA97, do not apply a minimum tax threshold, but rather require only an assessment of whether any tax is levied or not.

In developing our proposed solutions to our concerns, we have sought to ensure that any proposed solution is sufficiently targeted to the integrity rule to ensure that it does not provide taxpayers with an ability to still achieve inappropriate hybrid mismatch outcomes by structuring an arrangement to be subject to certain State taxes.

3. Applying the 10% minimum tax rate test in the integrity rule

Australia's hybrid mismatch regime, as enacted, is broadly in line with the recommendations proposed by the OCED as part of its BEPS Action Plan 2 – Neutralising the Effects of Hybrid Mismatch Arrangements. However, the Australian hybrid mismatch regime includes an additional integrity rule at Subdivision 832-J of the ITAA97.

The purpose of this targeted integrity rule is to prevent multinational groups from utilising low, or no, tax jurisdictions to fund their Australian subsidiaries, effectively replicating a hybrid deduction/non-inclusion arrangement without the hybrid element.

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As noted above, our primary concern is that the exclusion of municipal and State taxes from the definition of "foreign income tax" will give rise to inappropriate, and inconsistent, outcomes on application of the integrity rule where an Australian taxpayer makes payments of interest to a foreign Federal country which applies its income tax at a Federal, State and/or municipal level.

In our view, this concern is most effectively demonstrated by using the impact of the definition change on interest payments made by an Australian resident taxpayer to a Swiss resident taxpayer as an example.

In Switzerland, income tax is levied at the Federal, Cantonal (or State) and Communal (or municipal) level. At law, Swiss Cantonal taxes are harmonised across Switzerland and governed by the Swiss Federal Harmonization Tax Act, such that there is broad harmonisation of the taxation principles and rules, and Cantons and Communes are broadly limited to setting the rate of tax in their jurisdiction.

Tax assessments for Federal, Cantonal and Communal taxes are typically made simultaneously, within the same assessment procedure, and assessments are typically by the same Cantonal tax authority and by the same tax inspector. The Federal, Cantonal and Communal tax declarations are all made by the taxpayer in the very same tax return. Typically, the Cantonal tax authority issues the income tax assessment for all three taxes to the Swiss resident taxpayer. Further, the statutory tax rate applicable to the income of a Swiss resident company is often communicated by the Swiss tax authorities on an aggregated basis (i.e. combining Federal, Cantonal and Communal tax rates in one headline tax rate).

Therefore, in practice and in substance, each of the Federal, Cantonal and Communal taxes is clearly a foreign income tax which the interest payment is subject to, and the Swiss law is administered, in practice, as if they are one overall tax. Additionally, the collection of the Federal, Cantonal and Communal taxes is generally administered and coordinated by the Cantonal tax authority, which typically collects all of the taxes and then remits the related amount to the relevant Federal and Communal bodies. As discussed further below, both the Australia/Switzerland Double Tax Agreement, and Australia's existing Controlled Foreign Company (**CFC**) regime, acknowledge Swiss Cantonal and Communal taxes as income taxes (and in the latter case make modifications to ensure they are treated as such taxes for the purposes of Australia's CFC regime).

The Federal income tax rate in Switzerland is a flat rate of 8.5%, below the greater than 10% minimum tax rate of the integrity rule. However, whilst Cantonal and Communal tax rates vary between the jurisdictions, the total income tax rate applied to the income of Swiss resident companies is between 12% and 22%, clearly above the integrity rule's minimum greater than 10% tax rate. As noted above, the statutory tax rate applicable to the income of a Swiss resident company is typically communicated on an aggregated basis and the Federal, Cantonal and Communal taxes are collected via a single tax return by the Cantonal tax authority.

As a result, by excluding State and municipal taxes from the definition of foreign income tax for all purposes of Division 832 of the ITAA97, interest payments made by Australian resident taxpayers who are financed from a Swiss entity could be subject to the integrity rule as a result of satisfying section 832-725(g) of the ITAA97, notwithstanding that the interest payment is clearly subject to foreign income tax at a rate of greater than 10% in Switzerland.

This outcome is clearly inappropriate when contrasted with the application of the integrity rule to interest payments made by an Australian taxpayer to an entity tax resident in, as an example, Ireland. Ireland applies a single Federal income tax of 12.5% (equal to the lower end of the income tax rate a Swiss resident company may be subject to) to Irish resident corporations. As result, payments of interest made by an Australian taxpayer to an Irish resident taxpayer are not subject to the integrity rule, as they are subject to Federal income tax at a rate of greater than 10%.

In our view, it is inappropriate that interest payments made by an Australian resident taxpayer to a Swiss resident company are potentially subject to the integrity rule, but interest payments made to an Irish resident company are not subject to the integrity, even though those two interest payments would be subject to (at least) the same rate of income tax, merely because of the manner in which each country seeks to administer and collect that income tax.

Having regard to the example above, in our view it is inappropriate to have municipal and State taxes excluded from the definition of "foreign income tax" for the purposes of determining whether a payment of interest is subject to "foreign income tax" at the minimum tax rate of at least 10% when determining whether subdivision 832-J of the ITAA97 should apply to the payment, as this creates inconsistent outcomes based on how a foreign country elects to administer the collection of its tax, rather than the actual rate of foreign income tax which the income is subject too.

4. Applying the "principle purpose test"

In addition to the greater than 10% minimum tax requirement contained within the integrity rule, the integrity rule also includes a "principle purpose test" at section 832-725(h) of the ITAA97 which must be satisfied in order for the integrity rule to apply.

Broadly, in order for the integrity rule to apply it must be established that one of the principle purposes of the scheme was to enable foreign income tax to be imposed on the payment of interest under the scheme at a rate of 10% or less.

We do acknowledge, and appreciate, the clarification in paragraph 1.24 of the EM that *"the imposition of foreign municipal or State taxes on a payment would be factors that are relevant in determining whether it is reasonable to conclude that a principle 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".*

However, notwithstanding this statement in the EM, section 832-735(h) of the ITAA97 still uses the term "foreign income tax". As such, following the inclusion of the proposed section 832-130(7) in the law, which disregards municipal and State taxes for all purposes of Division 832 of the ITAA97, we are concerned that the legislation would be enacted in such a way that foreign State and municipal taxes are required to be excluded when assessing if foreign income tax is imposed at a rate of 10% or less under section 832-735(h) of the ITAA97.

It is only via the EM that there is clarification that State and municipal taxes may be applied when assessing the principle purpose of a scheme, creating significant uncertainty for taxpayers. In our view, the legislation should be enacted to apply as it is intended, rather than requiring taxpayers to rely on comments in the EM to be able to read the term "foreign income tax" differently when seeking to apply section 832-725(h) of the ITAA97 as opposed to when reading the term "foreign income tax" for all other purposes of Division 832 of the ITAA97.

4.1 Compliance burden

Further, the EM states that the purpose of the amendment to remove State and municipal taxes is to reduce the compliance burden on taxpayers. However, this is inconsistent with the stated intention of the law change to require taxpayers who make payments of interest which are subject to tax at a rate of greater than 10% to apply the principle purpose test in order to be able to include State and municipal taxes in determining whether the payment is subject to tax at a rate of greater than 10%. The requirement to make an assessment of principle purpose places a significantly greater compliance burden on the taxpayer, as well as giving rise to additional uncertainty for the taxpayer.

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It is for this reason that we recommend the definition of "foreign income tax" for the purposes of section 832-725 of the ITAA97 *not* disregard foreign State taxes and municipal taxes which, as, per the EM, is the intention when applying the principle purpose test. Further, given that the EM states that it is intended that State and municipal taxes are to be included when assessing whether a principle purpose of an arrangement was to have tax imposed on the payments at a rate of 10% or less, in our view by allowing taxpayers to include such State and municipal taxes when assessing whether the payment is subject to tax at a rate of greater than 10% for the purposes of section 832-725(g) of the ITAA97, this should reduce the compliance burden for taxpayers by removing the requirement to apply the more complex and uncertain assessment of purpose whilst still giving rise to the same outcome.

We also submit that, for the notable affected jurisdiction Switzerland, the evaluation of the taxation consequences for a payment at multiple levels of government does not in practice place "an unreasonable compliance burden on affected taxpayers" because of the manner in which Swiss taxes are reported and collected:

- Swiss cantonal tax laws – 26 in total – are harmonised across Switzerland and governed by the Swiss Federal Harmonization Tax Act, which in turn follows the taxation principles and rules as stipulated in the Swiss Direct Federal Tax Act governing the assessment and collection of federal income taxes. Insofar, there is a broad harmonisation of the different taxation levels, which are all based on the same / similar taxation principles and rules across Switzerland;
- The legislative authority of the Cantons and Communes in Cantonal / Communal tax matters is therefore limited as it must be compliant within the framework set by the federal laws. The Cantons and Communes, however, have unrestricted authority to autonomously decide on the applicable Cantonal and Communal tax rates;
- In addition, Swiss Federal, Cantonal and Communal taxes are generally assessed and collected by the same tax authority (i.e., the cantonal tax administration – generally the tax inspector); and
- Swiss Federal, Cantonal and Communal tax assessments are done simultaneously within the same assessment procedure for the particular tax period. Correspondingly, tax declarations are made by the taxpayer in the very same tax return (i.e., there are not separate tax returns for Federal and Cantonal/Communal tax purposes, the tax declarations are all done in the same return for Federal, Cantonal and Communal tax purposes).

In the absence of any identifiable policy reason for extending the State and municipal carve out to the integrity rule and, given the fact that the compliance burden would not seem to be a material consideration for jurisdictions such as Switzerland, it would be appropriate to remove this requirement for these jurisdictions (refer to section 8 for more detail discussion of potential legislative solutions).

5. Treatment of Swiss Cantonal and Communal taxes as Federal income taxes elsewhere in the law

As discussed above, Switzerland applies its income tax regime at the Federal, Cantonal (State) and Communal (municipal) level. It is this system which gives rise to our specific concerns regarding the potential application of the integrity rule following the exclusion of foreign State and municipal taxes from the definition of "foreign income tax".

Given this context, in our view it is important to acknowledge that specific modifications to the definition of foreign tax in Australia's CFC rules are already made to ensure that Swiss Cantonal taxes are treated as foreign income taxes for the purposes of those rules, given that Swiss Cantonal and Communal taxes are clearly income tax levied in a manner akin to a Federal income tax.

In this regard, Section 323 of the Income Tax Assessment Act 1936 (**ITAA36**) provides that:

If, apart from this section, a listed country or an unlisted country has both:

a) Federal foreign tax; and

b) State foreign tax;

the regulation may provide that a specific State foreign tax is to be treated, for the purposes of this Part, as if it were an additional federal foreign tax of the listed country or the unlisted country.

Section 21 of the Income Tax Assessment (1936 Act) Regulation 2015 then states that:

For section 323 of the Act, a foreign tax imposed in Switzerland that is a cantonal tax on income referred to in paragraph 3(b) of Article 2 of the Swiss convention (within the meaning of the International Tax Agreements Act 1953) is to be treated, for the purposes of Part X of the Act, as if it were an additional federal foreign tax of Switzerland.

Paragraph 3(b) of Article 2 of the Swiss convention states:

The existing taxes to which this Convention shall apply are in particular:
….
b) in Switzerland:
The federal, cantonal and communal taxes on income (total income, earned income income from capital, industrial and commercial profits, capital gains, and other items of income).

Having regard to the above, in our view excluding Swiss Cantonal and Communal taxes from the definition of "foreign income tax" for the purposes of Division 832 of the ITAA97 is not just inconsistent with the intended operation of the integrity rule, but also inconsistent with both Australia's Double Tax Agreement with Switzerland and the treatment of Swiss Cantonal and Communal taxes under Australia's domestic legislation.

Therefore, in our view, at the very least provision needs to be made in the law to ensure that Swiss Cantonal and Communal taxes are treated consistently in Subdivision 832-J of the ITAA97 as they are for other purposes of the Act by being considered a "foreign income tax".

6. Jurisdictions other than Switzerland

The examples provided in this submission focus on the potential inappropriate outcomes arising on interest payments made to a Swiss resident entity on the basis that this is the jurisdiction in which we have observed a clear case of taxpayers facing uncertainty regarding the application of the integrity rule to their financing arrangements, notwithstanding that interest payments made under those arrangements are clearly subject to "foreign income tax" at a rate of greater than 10%.

We acknowledge that there are potentially additional jurisdictions in which a similar outcome arises as a result of the method by which that jurisdiction allocates the right to tax the income of entities resident in its jurisdiction between its statutory bodies.

It is in this context that we have sought to provide proposed solutions to this issue which either deal with the identified concern across all jurisdictions, or provide flexibility for the law to be amended in the future to cover State and municipal taxes of other jurisdictions if required.

7. Similar amendments to UK hybrid mismatch regime

Prior to Australia introducing its hybrid mismatch regime into law, the UK enacted legislation to give effect to the recommendations of the OECDs BEPS Action Plan 2 and, as with Australia's hybrid mismatch regime, the UK's hybrid mismatch regime broadly enacts all of the OECD's recommendations. However, unlike Australia, the UK did not include an additional integrity rule.

Following the enacting of the UK's hybrid mismatch regime, amendments were made to the UK law to exclude from the definition of foreign tax taxes charged *"under the law of a province, state or other part of a country"* or *"levied or on behalf of a municipality or other local body"*.

That is, the UK made a similar amendment to its hybrid mismatch rules to exclude foreign state and local taxes from its definition of income tax.

We are advised by our colleagues based in the UK that the UK Treasury made this law change as a result of concerns regarding certain UK and US funding structures that did not fall within the remit of the UK's hybrid mismatch regime as a result of being subject to US State taxes whilst still economically achieving a deduction/non-inclusion outcome.

As stated above, we do not have any concerns with excluding foreign State and municipal taxes from the definition of "foreign income tax" for the purposes of Australia's "core" hybrid mismatch rules, as we acknowledge that the inclusion of such taxes within the definition of "foreign income tax" could potentially give rise to unintended outcomes such as those identified by the UK in relation to US state taxes.

However, for the reasons set out above, in our view excluding such State and municipal taxes from the definition of "foreign income tax" for the purposes of the integrity rule, a rule which the UK hybrid mismatch regime did not have an equivalent to consider when amending its law, gives rise to inappropriate, and inconsistent, outcomes for taxpayers. It is for this reason that we propose that the Australian law must be amended in a more specific way than the UK law when seeking to exclude State and municipal taxes.

8. Proposed solutions

In order to resolve the inappropriate outcomes of State or municipal taxes being excluded from the definition of "foreign income tax" for the purposes of applying the integrity rule, we would propose the following potential solutions:

1. *Disregarding the exclusion of State taxes and municipal taxes for the purposes of applying the integrity rule*

As discussed above, our concerns with the proposed change to the definition of "foreign income tax" for the purposes of Division 832 of the ITAA97 are limited to the implications of the exclusion of State and municipal taxes from the definition of "foreign income tax" when applying the integrity rule in Division 832-J of the ITAA97.

Further, as the integrity rule is seeking to apply a threshold minimum tax rate, rather than merely test whether foreign tax applies at all as the rest of the hybrid mismatch rules are, we are unable to identify any potential policy concerns for the Australian Treasury of not excluding foreign State and municipal taxes from the definition of "foreign income tax" for the purposes of the integrity rule.

Therefore, in order to address the concerns identified above, we would propose that the most effective, and efficient, solution would be to have the proposed subsections 832-130(7)(d) and (e) not apply for the purposes of Subdivision 832-J of the ITAA97. Such a solution would also not place an

unreasonable compliance burden on affected taxpayers, in particular not in jurisdictions such as Switzerland with a high level of tax harmonization across the different political levels.

2. *Providing for certain State and municipal taxes to be treated as federal taxes via the regulations*

Should it be considered that allowing all State and municipal taxes to be taken into account when applying the integrity rule in Subdivision 832-J of the ITAA97 may give rise to other unintended consequences, we would propose as an alternative solution that, in line with Australia's CFC rules, an additional section be included in Division 832 of the ITAA97 which allowed for certain State and municipal taxes to be considered Federal taxes for the purposes of Division 832 of the ITAA97.

This would then allow for foreign State and municipal taxes which were identified as being akin to Federal income taxes, such as Swiss Cantonal and Communal taxes, to be treated as such Federal income taxes for the purposes of Division 832 of the ITAA97. Further, this would also allow for specific adjustments to the definition of "foreign income tax" in Division 832 of the ITAA97 to be made via the regulations to ensure that the definition was consistent with the definition of income tax in all of Australia's Double Tax Agreements.

If the option were to be pursued, we would suggest that both section 323 of the ITAA36, and its associated regulation including Swiss Cantonal and Communal taxes as a Federal income tax for the purposes of Part X of the ITAA36, could be in effect replicated in Division 832 and the regulations of the ITAA97.

3. *Restricting the exclusion for State taxes and municipal taxes to only those taxes identified as a concern*

As a third alternative, the exclusion of foreign State and municipal taxes from the definition of "foreign income tax" for the purposes of Division 832 of the ITAA97 could be limited only to those foreign State and municipal taxes which were identified as potentially giving rise to concerns regarding the integrity of the operation of Division 832 of the ITAA97, such as US State taxes.

However, we would not consider this solution to be particularly efficient, as it would mean that the law would need to be amended each time a potential integrity concern was identified.

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APPENDIX 2

Liable Entity definition: Application to trusts

For the reasons discussed below, we are concerned that the proposed changes could result in inappropriate outcomes for trusts and their beneficiaries.

We have set out below our concerns, as well as our recommendations for how these concerns could be resolved.

1. Background to the proposed law change

A concept that is used throughout the hybrid legislation to determine the application of the legislation is that of a liable entity. Under section 832-325 an entity is a liable entity in respect of its own profits or those of another entity in Australia, if income tax is *imposed* on the entity in respect of all or part of its income or profits or those of the other entity for an income year. Similarly, an entity is a liable entity in respect of its own profits or those of another entity in a foreign country if foreign income tax is *imposed* in respect of all or part of its income or profits or those of the other entity for the foreign tax period.

The legislation does not state when tax is imposed on an entity. However, the definition of liable entity states at 832-320(4), to avoid doubt, an entity may be a liable entity even if the entity is *not subject to tax* or actually *liable to pay an amount of tax*.

Based on the explanatory memorandum to the *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018*, we consider these clarifications to be directed at circumstances where an entity has no actual income or profits (e.g., due to recoupment of a tax loss to offset taxable income in a particular year), or the entity has income or profits but they are not *subject* to tax (e.g., due to some exemption or carve-out), as opposed to transparency of the entity.

In the 2019-20 budget, recognising that the application of the foreign hybrid provisions to trusts, and in particular, the liable entity definition was not entirely clear, the Government announced it would make a number of technical amendments to the provisions. Specifically, the announcement provided:

> *The definition of a liable entity is used throughout the hybrid mismatch rules to broadly determine whether an entity is considered to be a taxpayer or simply a flow-through entity in a particular jurisdiction.*
>
> *However, under this definition, there is some uncertainty as to when a trust that applies Australian tax laws is a liable entity in Australia for these purposes. This proposed amendment will clarify that a trust will not be a liable entity in Australia if it is treated as a flow-through entity for Australian tax purposes. Such a trust may still be treated as a liable entity in a foreign country under the foreign country's laws. Trusts such as public trading trusts, complying superannuation entities, and trusts that have income to which beneficiaries are not presently entitled will be treated as liable entities in Australia.*
>
> *While a flow-through trust will not be a liable entity in Australia for the purpose of the hybrid mismatch rules, the beneficiaries of the trust may be considered to be liable entities. In such circumstances any hybrid mismatch outcomes reflected in the calculation of the trust's net income may be neutralised at the beneficiary level.*

However, Part 3 of the Bill proposes to add a new note to section 832-325(2) which says:

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Note 3: Another example is a test entity that is a trust to which Division 6 of Part III of the Income Tax Assessment Act 1936 applies. Each beneficiary who is presently entitled to a share of the income of the trust and who is not under any legal disability, and the trustee of the trust, are liable entities in respect of the income or profits of the trust.

This note indicates, in contrast to the original announcement, that at any one time, the trustee of a flow-through trust can be a liable entity in addition to the trust's beneficiaries. There are similar paragraphs in the explanatory memorandum to the Bill at 1.45 in relation to Division 6 trusts, and 1.46 in relation to AMITs.

2. Issues identified

Given the importance of the definition of "liable entity" to determining whether a hybrid mismatch arises we understand, and appreciate, Treasury's efforts to seek to clarify the definition.

However, in our view, the new proposed note 3 in the Bill in its current form and comments in the EM cause inappropriate outcomes for taxpayers. In our view, the proposed changes are inappropriate for the following reasons:

- They are inconsistent with the Government's earlier budget announcement (as set out above);
- They could cause trusts to become hybrid payers for the purpose of the hybrid mismatch rules in circumstances where hybridity does not arise.

3. Application to Hybrid Payer Mismatch

As noted above, our primary concern is that if both the trustee and its beneficiary were to be a liable entity at the same time, this would have unintended results when considering whether a Hybrid Mismatch as defined arises. This concern is best demonstrated when considering the application of the Hybrid payer mismatch to a foreign beneficiary of an Australian trust that makes a payment (e.g. of interest) to a foreign beneficiary, where both Australia and the foreign country view the foreign beneficiary as the ultimate taxpayer (i.e. opaque) and the trust as "flow-through". Clearly in this circumstance, as the tax systems of both countries treat the entities in the same manner, no hybridity arises.

However, if Note 3 and the explanation in the EM referred to above are read literally such that both the trustee and its beneficiaries are liable entities, the operative provisions result in the trust being treated as a hybrid payer for the purpose of section 830-320. This section says:

> **Hybrid payer**
> (1) An entity (the test entity) is a hybrid payer in relation to a payment it makes if:
> (a) subsection (2) applies to the entity in relation to a country and the payment; and
> (b) subsection (3) applies to the entity in relation to a different country and the payment.
>
> Note: The entity, the payments it makes, and its income or profits are identified disregarding tax provisions: see section 832-30.
>
> *Deducting country--entity is not grouped with recipient*
>
> (2) This subsection applies to a test entity in relation to a country (the deducting country) and a payment the test entity makes if:

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(a) the test entity, or another entity, is a * liable entity in the deducting country in respect of income or profits of the test entity (or a part of those income or profits); and
(b) that liable entity is not also a liable entity in the deducting country in respect of income or profits of the recipient of the payment.

Non-including country--entity is grouped with recipient

(3) This subsection applies to a test entity in relation to a country (a non-including country) and a payment the test entity makes if:

(a) the test entity, or another entity, is a * liable entity in the non-including country in respect of income or profits of the test entity (or a part of the income or profits); and
(b) that liable entity is also a liable entity in the non-including country in respect of income or profits of the recipient of the payment.

In applying subsection (2), as Australia would regard both the beneficiary and trustee as a liable entity, the trustee would be the liable entity in Australia in respect of the income or profits of the trust (for the purpose of (2)(a)), and it would not also be the liable entity in Australia in respect of the income or profits of the recipient (for the purpose of (2)(b)). Therefore, the requirement in subsection (2) would be met. Similarly, in applying (3)(a), the beneficiary would be the liable entity in the foreign country (given the foreign country regards the trust as transparent) and also the liable entity in that foreign country (for the purpose of (3)(b)). Therefore requirement (3) should also be met. As requirements in subsection (2) and (3) would be met, the trust would be a liable entity under subsection (1).

If the beneficiary were a tax-exempt entity in the foreign jurisdiction in respect of foreign source income only, the other requirements to neutralise a hybrid outcome under the hybrid payer mismatch provisions would also arise, including:

1. A deduction / non-inclusion mismatch would also arise (as required by 832-310) as the foreign entity would not be subject to foreign income tax because it is exempt; and
2. this would have been taxed in the foreign country if made by a payer in that country (as arguably required by 832-315(3)), because only foreign source payments are exempt in that country.

This is an inappropriate outcome in this circumstance given there is no hybrid mismatch in respect of the treatment of a trust in both jurisdictions.

The appropriate outcome, as suggested in the original budget announcement would be that in the case of a “flowthrough” trust, only the beneficiary would be the liable entity. If this interpretation were taken, only the beneficiary could be the liable entity in Australia in respect of the income of the trust for the purpose of (2)(a) above, and because that entity would also be the liable entity in Australia for the recipient, requirement (2) could not be met and the trust could not be a Hybrid Payer.

4. Proposed solutions

To resolve the inappropriate outcomes arising from the note and EM, they should both be expanded to clarify that while both a trust or trustee and a beneficiary can be a liable entity, they cannot both be a liable entity at the same time. Rather, the trust is the liable entity where “flowthrough”’ treatment does not apply (e.g. where the trust does not make beneficiaries presently entitled to its income or attribute its income to its beneficiaries, or is a public trading trust), and the beneficiaries are the liable entity where this treatment does apply. This should even be the case where the trustee is “assessed” to tax under Division 6 for foreign resident beneficiaries given the trustee is only assessed as a

mechanism to withhold tax on behalf of the foreign resident and therefore, again, it would be inappropriate to treat the trustee as a liable entity in this regard.

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APPENDIX 3

Subject to Australian Tax Definition: Application to Trusts

1. Background and issue identified

The effect of a hybrid mismatch may generally be reduced through the recognition of dual inclusion income as defined in section 832-680. That section provides that "[a]n amount of income or profits is ***dual inclusion income***" if it is "subject to Australian income tax" and "subject to foreign income tax" (or subject to foreign income tax in at least two countries).

"Subject to Australian income tax" is defined in section 832-125. It states:

> *(1) An amount of income or profits is **subject to Australian income tax** in an income year if it is an amount that is included in an entity's assessable income for the income year.*
>
> *(2) However, if:*
>
> *(a) the entity is a trust or partnership; and*
>
> *(b) the trust or partnership has net income for the income year;*
>
> *then the amount is only **subject to Australian income tax** to the extent it reasonably represents amounts:*
>
> *(c) included in the assessable income of another entity for the income year (other than an entity that is a partnership or the trustee of a trust); or*
>
> *(d) for a trust – on which the trustee is liable to be assessed and pay *tax.*

The flaw contained in the current drafting of the hybrid mismatch rules in relation to trusts is that in order for an amount of income or profits (which potentially includes an amount of gross income) to be included in dual inclusion income it must generally be reasonably represented in an amount reflected in the assessable income of a beneficiary of the trust (being a share of net income reduced by any allowable deductions of the trust).

To illustrate the above flaw, take the following example:

- Trustee Co is the Australian resident trustee of Trust A.
- Aus Co is the sole beneficiary of Trust A.
- For the 2020 income year, Trust A:
  - Derives $100 of assessable income; and
  - Incurs expenses which are allowable deductions of $80.
- Aus Co is an Australian tax resident company which is presently entitled to all of the income of Trust A and therefore required to include in its assessable income Trust A's net income of $20 for the 2020 income year.
- Trust A's income of $100 is subject to tax in Country X (as defined in section 832-130). Trust A is the entity liable to pay tax in respect of the income.
- Deductions of $80 are allowable in the calculation of Trust A's tax liability in Country X.

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Prima facie, the above example gives rise to a deducting hybrid because $80 of expenses are allowable as deductions in Australia and Country X.

Where the $100 was considered dual inclusion income then the mismatch described above should not have any impact on Trust A or Aus Co because the deducting hybrid mismatch should have a neutralising amount of nil and no amount of the $80 of expenses should be disallowed as a deduction.

However, as the definition of dual inclusion income relies an amount being included in the assessable income of an entity which is not a trust, the amount of dual inclusion income appears to be limited to $20 in this example (i.e. the amount of net income included in the assessable income of Aus Co). This results in $60 being disallowed as a deduction.

This result does not appear to reflect the intended effect of the hybrid mismatch rules which are targeted at neutralising the tax advantage of hybrid mismatches arising because of the differences in the tax treatment of an instrument or entity in two or more countries. Rather, the outcome reflects double taxation of the same income.

We note that the proposed section 832-30(4) makes clear that a reference in the Division to an amount being included in the assessable income of an entity is, in respect of a trust, taken to be a reference to an amount being included in the net income of a trust. However, based on the EM, this appears to be intended to address any concern that should the hybrid mismatch operate, any impact is to be treated as affecting the calculation of the net income of the trust. Accordingly, we do not consider it addresses the above issue.

2. Proposed solutions

In order to address this, we submit that section 832-125 should be amended as follows:

> *(2) However, if:*
>
> *(a) the entity is a trust or partnership; and*
>
> *(b) the trust or partnership has net income for the income year;*
>
> *then the amount is only subject to Australian income tax to the extent it reasonably represents amounts:*
>
> ***(c) included as assessable income in the calculation of the trust or partnership's net income for the income year and which are reflected in the share of net income of that trust or partnership included in the assessable income of another entity (other than an entity that is a partnership or the trustee of a trust); or***
>
> *(d) for a trust – on which the trustee is liable to be assessed and pay *tax.*

We submit that the above amendment should better reflect the objects of Division 832 as well as the stated aim set out in the Treasury statement of neutralising "any hybrid mismatch outcomes reflected in the calculation of the trust's net income… at the beneficiary level". Alternatively, a clarifying note could be added to section 832-125 to confirm the above intention.

For completeness, we note that section 832-125 and the proposed section 832-30 refer to the calculation of the net income of trusts. By virtue of section 95AAD of the Income Tax Assessment Act 1936, Division 6 of Part III of that Act does not apply to trusts which are AMITs. As a result, the concept of net income is not relevant to AMITs. Accordingly, we submit that further legislative

amendment is required in order to provide equivalent treatment for AMIT and non-AMIT trusts. Our proposed drafting above does not address this.

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