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Manager
Corporate and International Tax Division
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The Treasury
Langton Crescent
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By Email: *william.potts@treasury.gov.au*

Dear William

CLARIFYING THE OPERATION OF THE HYBRID MISMATCH RULES

1. Thank you for the opportunity to provide comments on the Exposure Draft Legislation *Treasury Laws Amendment (Measures for Consultation) Bill 2019: hybrid mismatch rules* ("**ED**") and the Draft Explanatory Materials ("**EM**") thereto.

2. Pitcher Partners specialises in advising clients in what is commonly referred to as the middle market. Accordingly, we service many clients that would be impacted by the proposed changes contained in the ED.

3. Appendix A contains our comments regarding the various changes proposed in the ED as well as the EM.

4. Furthermore, since the hybrid mismatch rules have become law, we have identified various issues with their operation in respect of trusts, partnerships and individuals. We have set out some of our concerns in this submission and our recommendations as to how these could be addressed in Appendix B. In summary, our main concerns with the operation of the hybrid mismatch rules are:

   4.1. Their application to individuals and SMEs where the cost of compliance is excessive when compared to the risk to revenue posed as well as the likelihood that there is widespread (inadvertent) non-compliance in this market segment;

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4.2. The concept of dual inclusion income for trusts and partnerships which requires tracing through chains of entities being overly complex, unnecessary and leading to inappropriate outcomes;

4.3. The current requirement under the dual inclusion income rules to consider the effect of foreign income tax offsets creating particular uncertainty for individuals and widely-held entities; and

4.4. That gross amounts subject to tax at high rates on a final withholding basis are not considered to be subject to Australian or foreign income for the purposes of the hybrid mismatch rules.

If you would like to discuss any aspect of this submission, please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director

APPENDIX A – COMMENTS RELATING TO THE EXPOSURE DRAFT

5. In this Appendix A, we provide our comments on Parts 1 to 6 of the ED and the accompanying EM.

Part 1 – MEC group referencing error

6. We understand that these changes are to ensure that members of a MEC group are treated in the same way as members of a consolidated group under the hybrid mismatch rules.

7. Our only comment is in relation to Item 1 and Item 22 of the ED, which appear to be inconsistent. That is,

   7.1. Item 1 is seeking to amend a note that Item 22 is seeking to repeal; and

   7.2. Item 22 proposes new Note 1 to subsection 832-30(1) which does not include the words "subsidiary member of a consolidated group or MEC Group".

8. We believe a simple amendment to Item 22 would likely address this issue with no need for Item 1.

Part 2 – State and municipal foreign taxes

9. For the reasons outlined below, we believe the amendments to be made in Part 2 need further consideration and will result in unintended outcomes. We therefore do not support these amendments in their current form.

Commentary in EM as to the purpose of the amendments

10. Paragraph 1.20 of the EM suggests that the amendments proposed by this Part are to alleviate the unreasonable compliance burden for taxpayers who may have to consider the taxation consequences of a payment at multiple levels of government.

11. Our initial impression is that while the amendments may result in a reduction in compliance in some cases, they will be seen to address a perceived integrity risk in situations where a deductible payment in Australia is not subject to foreign tax at the federal level but is subject to tax at the State level (at a low rate such that there would not be a deduction/non-inclusion outcome). If the ED is seeking to address this perceived risk, we suggest that the final EM make this explicit.

12. We note that the foreign income tax offset rules in Division 770[1] do not distinguish between Federal and State taxes and these are not seen to impose an unreasonable compliance burden on taxpayers.

13. Additionally, the effect of the amendments could result in an entity not being a liable entity, not being subject to tax, and an amount not being a foreign income tax deduction (when the amount otherwise would have been prior to the amendments).

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[1] All legislative references are to the *Income Tax Assessment Act 1997* ("**ITAA 1997**") unless otherwise specified.

14. By disregarding foreign municipal or State taxes from being considered a "foreign income tax" under the hybrid mismatch rules, these changes are likely to have two effects:

    14.1. reduce the occasions where a transaction may give rise to a deduction/deduction mismatch; but

    14.2. increase the occasions where a transaction gives rise to a deduction/non-inclusion mismatch.

Consistency with the FITO rules and dual inclusion income

15. Where taxpayers are already complying with Division 770 in determining their foreign income tax offsets ("**FITOs**"), the amendments in Part 2 of the ED have the potential to significantly increase complexity and compliance costs when applying the dual inclusion income rules.

16. We note that the ED does not propose to amend the reference to "foreign income tax" in paragraph 832-680(2)(b). Therefore, in determining the neutralising amount in respect of a hybrid payer or deducting hybrid mismatch, a taxpayer would have to consider State and municipal taxes on income in any case.

Consistency with accounting for income taxes

17. The term "foreign income tax" is limited to those taxes that are calculated on "income", "profits or gains, whether of an income or capital nature", and any other taxes subject to a tax treaty. Generally speaking, this definition is consistent with most treaties in terms of being applicable generally to income taxes and capital gains taxes.

18. We note that most large multinational enterprises would be required to comply with AASB 112 or its equivalent under US GAAP or IFRS. These standards would require identification of all "income taxes". Accordingly, we would be unsure why large MNEs would not be identifying all taxes on income and profits for accounting and reporting purposes.

19. In comparison, however, we note that most SMEs do not prepare financial statements in accordance with AASB 112 or IFRS and thus would have less access to information that would help to determine the type of taxes being paid in a foreign jurisdiction. By way of example, whether a tax paid is a withholding type tax or a State tax. Accordingly, limiting the definition of taxes is (in our view) likely to result in more compliance in terms of identifying correctly whether the relevant taxes being paid are within the meaning of foreign income tax in proposed section 832-130(7).

Integrity rule interaction

20. Paragraph 1.24 of the EM highlights that some payments that, under the existing law, would not be subject to the integrity rule in Subdivision 832-J, may now be caught if the principal purpose test is met. For example, where a payment of interest is subject to tax in a foreign country at 8% at the federal level and 4% at the State level, only the federal tax of 8% will be taken into account under paragraph 832-725(1)(g).

21. The EM notes however, that foreign municipal or State taxes will be taken into account when applying the principal purpose test. Our understanding is that the policy of the integrity rule is to ensure that a hybrid financial instrument mismatch cannot be effectively replicated by interposing a low or zero rate entity between the ultimate parent entity and the Australian subsidiary. For these purposes, the payment was not considered to be sufficiently "included" if foreign tax of 10% or less applied to it.

22. Taxpayers would generally be indifferent whether their income tax is payable to a federal, State or municipal government. If the total tax on the item of interest income exceeds 10% in a particular foreign country, it would be more consistent with the underlying policy to treat the payment as not subject to the integrity rule.

23. Therefore, we recommend that specific amendments are made to section 832-725 to modify the definition of "subject to foreign income tax" to not include references to paragraphs 832-130(7)(d)-(e) that are proposed under Item 13 of the ED.

24. This would provide taxpayers with certainty and reduce compliance costs in cases where the foreign municipal or State tax would be the difference between whether or not the payment is subject to foreign income tax of 10% or less.

Swiss cantonal taxes

25. We also note that Treasury should consider if a specific modification needs to be made to cover Swiss cantonal taxes similar to that contained in regulation 21 of the *Income Tax Assessment (1936 Act) Regulation 2015*. The regulation treats cantonal taxes on income in Switzerland referred to in the Australia-Switzerland double tax agreement as a federal foreign tax for the purposes of the CFC rules contained in Part X of the *Income Tax Assessment Act 1936* ("**ITAA 1936**"). This has the effect, for example, of modifying when a dividend is considered to be taxed at the normal company rate under section 325 of the ITAA 1936.

26. We understand that cantonal taxes in Switzerland can often be levied at a fairly high rate for a non-federal income tax. We therefore suggest that Treasury consider whether a specific modification similar to that in regulation 152G needs to be inserted into the hybrid mismatch rules.

Part 3 – Entities

27. We are concerned that the amendments proposed in Part 3 of the ED will give rise to significant ambiguities. We understand that proposed subsections 832-30(2)-(6) are primarily intended to apply for the purposes of avoiding doubt that, for transactions involving legal persons acting in their capacity as trustees of trusts or as partners on behalf of partnerships, the hybrid mismatch rules are intended to apply to the trust or partnership that is recognised as the entity for tax purposes.

28. However, we query whether this clarification is necessary as it is commonly understood that Australia's tax rules operate in this manner already as per section 960-100 and in particular subsection 960-100(4). We note that there appears to be nothing overly unique about the hybrid mismatch rules that requires this specific clarification.

29. Further, proposed subsection 832-30(4) in the ED also appears to be for the avoidance of doubt rather than achieving a substantive modification necessary for the proper operation of the hybrid mismatch rules. This is because almost every provision in the income tax legislation which includes an amount in assessable income of an entity or disallows or allows a deduction to an entity is understood to be taken into account in calculating the net income of a trust or partnership where that entity is a trust or partnership.

30. Our view is that, despite proposed subsection 832-30(6), these proposed statutory provisions may only work to create more confusion about the operation of other provisions contained in the Act.

31. As such we recommend that these proposed provisions would be more appropriate as comments in an EM or administrative guidance rather than substantive law. Alternatively, to the extent that a provision clarifies the operation of an existing provision, we would recommend that Treasury consider using the words "To avoid doubt, … ".

32. Finally, to the extent that Treasury believes amendments are required to clarify how certain provisions apply to trusts and partnerships, consideration could be given to how this has been legislated elsewhere (e.g. Division 7A of Part III of the *Income Tax Assessment Act 1936* contains section 109ZE which clarifies the entity concept, which is noted in the operation of section 109K for company-to-company transactions).

Liable entity

33. We reference item 25 of the ED and the comments in the EM relating to this.

34. We understand that the proposed Note 3 to subsection 832-325(2) seeks to provide clarification that presently entitled beneficiaries and trustees are generally liable entities in respect of a trust's income or profits.

35. We note that this may also be seen as ambiguous as the EM does not make it clear whether a trustee is a liable entity of a trust in situations where beneficiaries are presently entitled to all of the income of the trust in a given year. For example, paragraph 1.44 EM states that both the trustee and each beneficiary is also a liable entity of the trust "in some circumstances". It would be useful if the EM could provide an example where they both are liable entities with respect to the net income of the trust, or where only one is considered to be a liable entity with respect to the net income of the trust.

36. Further, we query whether the guidance in the EM is consistent with the effective operation of the hybrid mismatch rules. While the proposed Note 3 and the EM guidance provides useful explanations of what section 832-325 means as currently drafted (i.e. it explains when a trustee is considered to be a liable entity in respect of the income or profits of a trust), it may be the case that the current law does not achieve appropriate outcomes where the trustee is viewed as a separate entity to the trust.

37. In this regard, it may be necessary for a modification to be made to deem the trust itself to be a liable entity which would be inconsistent with proposed

subsection 832-30(5). If Australia's tax laws view the trust as the entity making a payment, it may also be necessary for the hybrid mismatch rules to view the trust itself (and not the trustee) as being the liable entity in Australia in respect of the trust's profits. If this does not occur, we believe that complications will occur when trying to apply the specific hybrid mismatch rules.

38. By way of an easy example, a complying superannuation fund or a public trading trust, where the trustee is considered the liable entity on the income or profits of the entity, would be considered a reverse hybrid under section 832-410 in almost all circumstances, even though a reverse hybrid is understood to be a transparent or flow-through entity in the country of formation[2]. This would clearly be an unintended outcome.

39. We are intending to provide some examples separately to this submission to explain our thinking on this issue and to assist us in further providing recommendations.

Other matters

40. We highlight below some suggested recommendations to the ED in its current form from a drafting perspective:

    40.1. We are not sure if a reference to "dispose" or "other property" in proposed subsection 832-30(2)(b) is necessary as neither of these terms appear to be currently present in Division 832. As such, they may have no effect. If required, it may be useful to explain the reasoning for this provision in the EM.

    40.2. The reference to "subsection (1)" in proposed subsection 832-30(3) appears confusing as subsection (1) does not recognise things being done in the way that subsection (2) expressly does so. Subsection (1) only operates to disregard certain statutory provisions in determining something and it does not otherwise take an entity to do a thing.

    40.3. Proposed subsection 832-30(4) should also include a reference to "*partnership loss".

    40.4. The heading for proposed subsection 832-325(5) may be more appropriately phrased as "This section does not make an entity that is not a legal person a taxpayer". The term "non-legal person" is somewhat confusing as a person is understood to be an individual or a company (or in some cases other incorporated entities with legal personality). However, a trust or partnership would not ordinarily be considered to be either a person or a non-legal person. Using the term "person" rather than "entity" is therefore ambiguous.

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[2] With reference to subsection 832-410(2), the superannuation fund is the test entity and it is formed in Australia. Under the ED, the superannuation fund would not be considered a liable entity, but rather the trustee would. Accordingly, the superannuation fund would appear to meet the definition in subsection (2). The trustee (i.e. a company or individual) would be regarded as the "investor" under the defined term of subsection (2) and thus may also be a liable entity in another foreign jurisdiction such that subsection (3) is satisfied.

Part 4 – Dual inclusion income

41. We have no comments regarding the provisions in the ED that address concerns regarding the on-payment rule and ensuring that it operates effectively where payments are made through a chain of entities.

42. However, we suggest that Example 1.1 in the EM could include some additional facts to make the example clearer. We suggest that the example could include statements to the effect that:

    42.1. the classification of Aus Head Co for Australian purposes (a company that is taxable on its own income or profits) and for the purposes of the foreign country (a disregarded entity), which currently appears to be implicit rather than explicit;

    42.2. the income derived by Aus Sub 2 is not subject to tax in Country B under its CFC rules to clarify that such amounts are not already dual inclusion income before the application of the on-payment rule; and

    42.3. the interest income derived by Aus Sub 1 is not subject to tax in Country B under its CFC rules to clarify that this first payment of interest is not dual inclusion income after the first application of new subsection 832-680(5).

Part 5 – Hybrid entities integrity rule

43. Our comments on the amendments to the integrity rule relate to the examples in the EM.

44. Regarding example 1.2, the EM would be clearer if it explained why the payment of interest to Interposed Foreign Co gives rise to a deduction/deduction mismatch as this is not immediately evident from the facts and may be incorrect in certain circumstances.

45. For example, if Aus Co is disregarded as an entity separate from the head company of the Global Co group in the country in which it is headquartered, such an intra-group payment is likely to give rise to a hybrid payer mismatch rather than a deducting hybrid mismatch. Under the ordering rule in subsection 832-545, a payment will not give rise to a deducting hybrid mismatch if it gives rise to a hybrid payer mismatch. In these circumstances, the outcomes in example 1.2 will not arise under the proposed amendments in the ED as Part 5 does not seek to amend the way in which the integrity rule interact with the hybrid payer mismatch rules.

46. In general, deducting hybrid mismatches are understood to arise in relation to third party (rather than intra-group) payments, while the integrity rule only applies in the context of related-party payments. Therefore, it would assist if the example is made clearer to explain the circumstance that results in the payment giving rise to both a deducting hybrid mismatch and one within the scope of the integrity rule (i.e. a payment to an interposed foreign entity within the same Division 832 control group).

47. Example 1.3 appears to result in a double non-deduction outcome as the primary response country may deny the foreign income tax deduction under its foreign hybrid mismatch rules and the integrity rule will operate to deny the deduction in Australia.

While the dual denial of deduction may be the policy intent in this situation (i.e. because the denial of a deduction in a foreign country in respect of income taxed at 10% or less may not be seen as necessarily punitive), this may create some complex interactions with hybrid mismatch rules in other countries. This is explained below:

47.1. If the integrity rule applies to deny a deduction in Australia, the foreign country may not consider the payment to give rise to a deduction/deduction outcome as there will be no deduction in Australia.

47.2. It may be the case that under the primary response country's laws there is a rule that corresponds to subsection 832-120(3), whereby the effect of another country's hybrid mismatch rules is disregarded in determining whether a loss or outgoing gives rise to a foreign income tax deduction. However, the integrity rule in Subdivision 832-J may not be considered to be a rule that corresponds to or is sufficiently similar to that country's hybrid mismatch rules. This is because the integrity rule is unique to Australia and not otherwise present in the OECD Action 2 Report.

47.3. Therefore, the result of the amendments to the integrity rule proposed in the ED may be have the effect of preventing foreign countries from being able to deny deductions as the primary response country under their deducting hybrid rules.

Part 6 – Foreign income tax deductions for regulatory capital

48. We note that proposed subsection 207-158 in the ED makes reference to the company's requirement to provide a distribution statement under Subdivision 202-E.

49. In general, (i.e. not only in relation to distributions on non-share equity interests that are Additional Tier 1 capital), section 207-158 may apply where a franked distribution gives rise to a foreign tax deduction (e.g. the company applied funds raised in relation to the relevant equity interest in deriving foreign income where the distributions to the interest holders are considered to be returns on debt interests in the foreign country). In such instances, the interest holders would not have the information available to self-assess whether section 207-158 applies, particularly where they are smaller investors.

50. Where section 207-158 is satisfied, subsection 207-145(1) applies to turn off the gross-up and credit outcome under the ordinary operation of the imputation system. It does not make the distribution unfrankable under section 202-45.

51. At present, there is no express requirement under section 207-158 (including the new section 207-158 proposed by the ED) nor in Subdivision 202-E to notify the investor of this result in relation to their distribution. While paragraph 202-80(3)(g) requires the corporate tax entity to provide any other information relevant to imputation generally or the distribution, the approved form[3] does not appear to require information regarding the operation to section 207-158 to be disclosed.

[3] https://www.ato.gov.au/Business/Imputation/Paying-dividends-and-other-distributions/Issuing-distribution-statements/

52. Therefore, this may result in certain taxpayers not being able to comply with their tax obligations if the corporate tax entity does not communicate this information to the equity interest holder.

53. We suggest that section 202-80 (within Subdivision 202-E) be amended to make it an express obligation of the corporate tax entity preparing the distribution statement to disclose in the statement whether or not section 207-158 applies to all or some of the distribution.

APPENDIX B – CONCERNS WITH THE OPERATION OF EXISITNG PROVISIONS

54. In this Appendix B, we have highlighted our priority items that we believe require legislative attention with respect to the operation of Division 832. While we understand that Treasury may not be able to deal with these issues in the ED, we would appreciate that the Minister considers these issues as part of the consultation process.

55. We would welcome an announcement by the Government to address these concerns that we have raised as they are currently giving rise to significant uncertainty and compliance concerns on the operation of Division 832 to taxpayers in the middle market.

56. We attach at Appendix C a document we prepared for discussion with the ATO containing worked examples that illustrate in more detail the concepts highlighted below.

57. Further, we attach at Appendix D a document we prepared that followed on from the initial discussions which suggested some potential interpretations that could make the rules workable. We note that these suggestions may not be supportable on the current wording of the law and legislative amendment may be more appropriate. Accordingly, we offer recommendations in this regard below.

58. Note that Appendix D includes a detailed analysis of how the deducting hybrid rules apply to individuals and the extraordinary complexity that is required to properly comply with the provisions. Our recommendation is that individuals (and other SMEs which may predominantly distribute income to individuals) be exempt from being entities that could be considered deducting hybrids to save such entities significant compliance costs relative to the value of transactions that occur in this market segment.

Issue 1: Application to individuals and middle market taxpayers

59. Paragraph 1.6 of the EM states that:

> *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.*
>
> *[emphasis added]*

60. This was also stated in paragraph 1.14 of the Explanatory Memorandum to the *Tax Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018* which introduced the hybrid mismatch rules into Australia's tax laws.

61. The ATO webpage relating to hybrid mismatch rules[4] (which is contained in the "International tax for business" section of the website) states that:

[4] https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Hybrid-mismatch-rules/

> *The hybrid mismatch rules received royal assent on 24 August 2018. They are designed to prevent multinational companies from gaining an unfair competitive advantage by avoiding income tax or obtaining double tax benefits through hybrid mismatch arrangements.*
>
> *[emphasis added]*

62. Both the stated objective of Parliament and the focus of the ATO in relation to the hybrid mismatch has been large multinational groups. However, as the rules do not exempt individuals, low value transactions or SME taxpayers, the reality is that they apply to a multitude of ordinary transactions of relatively small amounts entered into by individuals or trusts. This could include where an individual or a trust has a single foreign rental property, foreign bank account, derives foreign employment income, has any dealings with a foreign entity or even where they simply hold shares in an Australian listed company.[5]

63. The hybrid mismatch rules are extremely complex and, from their origins in the OECD BEPS Project, were clearly only ever implemented with multinational corporate groups in mind. The administration of the rules since their implementation has been consistent with this. The hybrid mismatch rules are not something on the radar of small businesses and individuals. The ATO has not publicly communicated the impact of these rules on this segment of the population and most tax agents serving this market segment would not generally consider how the rules apply to their clients.

64. The reality is that the operation of the hybrid mismatch rules in relation to the vast majority of individuals and SME taxpayers is being largely ignored by taxpayers and administrators through a lack of knowledge rather than through deliberate non-compliance. We suggest this is not an appropriate way for Australia's tax laws to operate.

65. Furthermore, the cost of complying with the provisions is significantly disproportionate to the integrity risk posed by this group of taxpayers. Accordingly, we fear that many taxpayers in this space are not obtaining appropriate advice on the operation of the provisions to their circumstances, or that their advisors may not be appropriately identifying whether the provisions operate in certain circumstances.

66. Generally, where tax integrity measures are introduced that are of significant complexity, smaller taxpayers or transactions are carved out or a *de minimis* exemption is provided in order to reduce compliance costs.[6]

67. Further to the complexity of the hybrid mismatch rules more broadly, our experience has been that the hybrid mismatch rules are far more complex for individuals where an individual is a deducting hybrid and has dual inclusion income that gave rise to FITOs.

    67.1. In calculating the amount of income or profits of the individual that are subject to Australian tax, the effect of the FITO has to be considered under subsection 832-680(2). The individual has to compare the FITO with the amount of tax

[5] Refer to our comments above in relation to the application of section 207-158.

[6] For example, see Subdivisions 165-CC and 165-CD relating to unrealised company losses and the value shifting regime in Part 3-95.

would be payable on the assessable amount at the “rate of tax imposed” on that individual.

67.2. Unlike companies and superannuation funds, individuals may tax at marginal rates. This raises the issue of whether the rate of tax is the individual’s marginal rate, their average rate or the rate that would apply if the amount of income or profits was the first dollar earned. Additionally, individuals are subject to other levies and are entitled to tax offsets which are wholly dependent on taxable income for a year which further complicates this analysis.

67.3. When performing this analysis, one quickly realises that their answer keeps changing because the individual’s rate of tax changes once a deduction is denied that changes their taxable income for the year.

67.4. We have performed some very detailed analysis and considered various scenarios in order to work out practical solutions to the issues we have outlined. Ultimately, we believe that very complicated iterative calculations are required to properly determine the amount of dual inclusion income for individuals (and consequently for trusts and partnerships that distribute to individuals).

67.5. This level of complexity is far beyond what is appropriate for individuals who would generally deal with immaterial amounts in comparison to multinational corporations.

68. We recommend that, consistent with the other integrity measures mentioned above and to reflect the reality of how the laws are being applied and enforced in practice, the hybrid mismatch rules should be amended to exclude individuals and SMEs. If Treasury is concerned about some high-wealth individuals exploiting the rules, then perhaps some *de minimis* could apply (e.g. to the quantum of hybrid mismatches or to the value of net assets of the individual or SME entity).

69. For example, the concept of the maximum net asset value test in section 152-15 could be applied to determine which entities would not have to apply the hybrid mismatch rules and appropriately modified to an appropriate amount other than $6,000,000. Additionally, an annual test could exclude taxpayers based on the totality of hybrid mismatches that arise during the year (on an associate-inclusive basis). By way of comparison, there is an exclusion to the value shifting rules under section 727-15 where an indirect value shift does not exceed a transaction value threshold. Similarly, the thin capitalisation provisions in Division 830 contain a transaction threshold exclusion for SMEs. We would be happy to discuss with you how an appropriate SME exclusion could be built into the provisions.

70. Alternatively, we believe that the hybrid mismatch rules could be significantly simplified if individuals and SMEs were excluded from being deducting hybrids as the deducting hybrid mismatch is the one that predominantly affects individuals and trusts entering into ordinary commercial transactions. Where such entities are affected by the other hybrid mismatches, it may be appropriate for the rules to apply:

70.1. Hybrid financial instrument mismatch – this would ensure that individuals and other SME entities cannot obtain benefits where a foreign entity lends to the individual in a way that exploits the differences in the tax rules that countries adopt in relation to financial instruments.

70.2. Hybrid payer mismatch – this would ensure that where individuals and other SME entities elect to treat subsidiary companies as transparent entities under the laws of a foreign country, they cannot achieve a deduction/non-inclusion outcome.

70.3. Reverse hybrid and branch hybrid mismatch – this would ensure that reverse hybrid entities and branch hybrids cannot enter into schemes with Australian individuals and SME entities that result in a deduction/non-inclusion outcome by, for example, offering them favourable terms that are only commercial because of the non-inclusion outcome.

Issue 2: Dual inclusion income issues for trusts and partnerships

71. We have also encountered various issues when calculating dual inclusion income for flow-through trusts and partnerships. We have separately prepared various examples and have discussed these with the ATO and it is our impression that the ATO have recognised significant difficulties exist and that the law as written could not be interpreted in a way to achieve a sensible outcome in all cases.

72. In essence, the difficulties are caused by the requirement for an amount of income or profits of a trust or partnership to be considered to be subject to Australian income tax under subsection 832-125(2). Where that trust or partnership has net income for the year, an amount of assessable income derived by the trust or partnership must reasonably represent amounts included in the assessable income of another entity in that income year.

73. These gives rise to significant uncertainty when dealing with deductions. For example, if a trust or partnership in a loss position for the year (i.e. no net income) has derived $1,000,000 of assessable income that was also subject to foreign income tax, then the entire $1,000,000 would be considered dual inclusion income and therefore may allow the entity to be able to deduct $1,000,000 that otherwise gave rise to a hybrid payer or deducting hybrid mismatch.

74. If, however, the trust or partnership had $1 of net income that year, then one view is that only $1 can be considered as dual inclusion income as only $1 is included in the assessable income of the beneficiary or the partner. Another view is that the $1 share of the net income assessable to the beneficiary or partner reasonable represents the entire $1,000,000 that was a component in the calculation of the trust or partnership's assessable income. However, there is no specific rule to convert a net assessable amount into its underlying constituent components on an item-by-item basis in a similar way that subsection 832-110 coverts the gross item-by-item amounts into one net deduction representing the share in the net loss of a partnership.

75. This $1 difference in net income could have vastly disproportionate tax consequences if the better view is that only $1 could be dual inclusion income for the year in such circumstances. This would mean it would be more favourable for a loss entity

applying the rules than one that has net income. However, even if the trust or partnership with net income has no deductions in that year to give rise to this issue, if that entity distributes to another trust or partnership that is a loss entity then it may be the case that no amount is recognised as dual inclusion income as paragraph 832-125(2)(c) does not consider the amount subject to Australian income tax unless it is ultimately included in the assessable income of an entity that is not a trust or partnership. This means that the trust or partnership which derived the amount that was subject to foreign income tax would end up with vastly different outcomes if it distributes to a loss company as compared to a *trust or partnership* with losses. In our view there is no logical reason why this should be the case and why a different outcome should occur.

76. This "trace-through" approach in subsection 832-125(2) would in many cases make the rules entirely unpractical to comply with or administer where distributions flow through many layers of entities, each with their own deductions. On top of this, the modification in subsection 832-680(2) that then reduces the amount based on the amount of tax sheltered by FITOs makes this an exponentially harder, if not impossible, task.

77. In summary, these issues make the application of subsection 832-125(2) both unworkable and otherwise resulting in unusual or unintended outcomes. We suggest that if a trust or partnership has included an amount of income or profits in its assessable income in calculating its taxable net income for the year, this should be considered to be subject to Australian tax such that there is no need for the subsection. Once an amount is included in net income under Division 5 or Division 6 of Part III of the *Income Tax Assessment Act 1936*, those Divisions deal with the amount appropriately and there is no reason why the amount should not be considered to be subject to Australian tax once this has occurred.

78. We understand that this approach could give rise to issues in applying subsection 832-680(2) where FITOs flow through the trust or partnership. However, this would be better dealt with by a specific modification to subsection 832-680(2) whereby the trust or partnership has to calculate the extent to which the FITO has ultimately sheltered amounts of assessable income that reasonably represented the amount that was assessable to the trust or partnership that gave rise to the FITO.

79. If, despite our comments, Treasury believe subsection 832-125(2) is necessary, then we suggest that paragraph 832-125(2)(c) be modified so that the reference to another entity "(other than an entity that is a partnership or the trustee of a trust)" becomes "(other than an entity that is a partnership or a trust that has net income for the income year)". This would at least ensure that inconsistent outcomes would not arise when the first trust or partnership distributes to a loss trust or loss partnership as compared to a loss company. This would still require an entity to trace through to the ultimate recipient in the chain where the first recipient does have net income. However, this modified approach would allow the distributions to end at a loss entity and still be considered to be subject to Australian income tax, regardless of the kind of entity the loss entity is.

80. A further recommended change, if subsection 832-125(2) is seen to be necessary, is to include a reconstruction rule similar to that in subsection 832-110(5) but which operates in the opposite direction (i.e. the beneficiary or partner who is assessable on

a net amount can be taken to have been assessable on the gross amounts which were taken into account in calculating that net amount). Such a rule should only be limited in scope and only apply for the purposes of determining dual inclusion income of a trust or partnership, as it would otherwise significantly complicate the operation of the whole Division.

81. Note that we also suggest that the reference to “the trustee of a trust” in paragraph 832-125(2)(c) is confusing, particularly in light of the proposed changes to section 832-30 in Part 3 of the ED as well as the other provisions in section 832-125 itself which refer to the trust being the entity that has included the assessable income rather than the trustee.

Widely-held flow through entities

82. Where the entity applying the rules is a widely-held flow through entity (e.g. a managed fund), it would be required to know how all of its unitholders subsequently deal with their distributions, what deductions they claim and what rate of tax they are paying on their taxable income. Given that multiple tax rates apply to individuals, complying superannuation funds (i.e. to the extent they are in pension mode) and companies (i.e. it could be a base rate entity or not), and given that distributions may flow through multiple tiers of trusts, none of these things can be assumed. Further, the widely-held trust would need to determine this before its unitholders have necessarily lodged their tax returns for the income year.

83. This would make compliance extremely costly and practically impossible for widely-held trusts and partnerships. Treasury could consider providing a shortcut or concessional treatment for such entities to recognise such impracticalities.[7]

84. One possibility would be to allow sufficiently widely-held entities to be able to assume the rate of tax imposed on its members. Where the widely-held entity can reasonably conclude that a member is not itself a flow-through entity (i.e. for direct holdings) it could be given an assumed tax rate for companies (e.g. 30%), superannuation funds (e.g. 10%) and individuals (e.g. 25%). Where the members are flow-through entities such as other trusts such that the ultimate company, individual or superannuation fund that is the beneficial owner is unknown, the widely-held entity could be able to assume a blended rate (e.g. 20%) in determining dual inclusion income. This may, in itself, be regarded as very complex. Accordingly, Treasury may regard 30% as being an appropriate shortcut rate to apply for widely-held flow-through entities.

85. Such an approach would require deeper analysis to determine appropriate shortcuts. However, we feel that some type of shortcut is ultimately necessary for such widely-held entities to be able to comply with the hybrid mismatch rules.

[7] For example, Division 166 provides concessional tracing rules for widely-held companies that recognise the impracticalities of tracking ultimate beneficial ownership of its shares at all times of the purposes of the company loss rules. Section 124-783 contains exclusions for widely-held companies or trusts with at least 300 members/beneficiaries from the significant and common stakeholder rules under the scrip-for-scrip roll-over.

Issue 3: “Subject to tax” not including withholding taxes

86. We strongly disagree that withholding taxes should not be included within the definition of a foreign income tax or Australian income tax. From an Australian income tax perspective, this results in income that is subject to tax at a 30% rate (e.g. royalty withholding tax or taxes on unfranked dividends) being treated as though they were not subject to tax.

87. Likewise, where substantial final withholding taxes are paid in a foreign jurisdiction it is not appropriate for a payment not considered to have been appropriately taxed for the purposes of the hybrid mismatch rules.

88. We would like to better understand why Treasury believes that such taxes should be carved out of the definition of foreign income tax and why this provides appropriate outcomes. Once we better understand the integrity risks, we would like an opportunity to provide further comments on this point.

APPENDIX C – DETAILED EXAMPLES OF MIDDLE MARKET ISSUES

89. Please see separately attached document.

APPENDIX D – ANALYSIS OF ISSUES RELATING TO DUAL INCLUSION INCOME

90. Please see separately attached document.