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PROPERTY COUNCIL of Australia

Australia's property industry
Creating for Generations

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Manager
Corporate and International Tax Division
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Langton Cres
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By email: william.potts@treasury.gov.au

Dear William,

Tax Integrity – Clarifying the Operation of the Hybrid Mismatch Rules

The Property Council welcomes the opportunity to provide comments on the *Treasury Laws Amendment (Measures for Consultation) Bill 2019: hybrid mismatch rules* exposure draft legislation and explanatory materials amending the hybrid mismatch rules (the draft legislation), released in December 2019.

The Property Council of Australia champions the industry that employs 1.4 million Australians and shapes the future of our communities and cities. Property Council members invest in, design, build and manage places that matter to Australians: our homes, retirement villages, shopping centres, office buildings, industrial areas, education, research and health precincts, tourism and hospitality venues and more.

On behalf of our members, we provide the research and thought leadership to help decision-makers create vibrant communities, great cities and strong economies. We support smarter planning, better infrastructure, sustainability, and globally competitive investment and tax settings which underpin the contribution our members make to the economic prosperity and social well-being of Australians.

Industry has noted Treasury's recognition that currently there is uncertainty in how hybrid mismatch rules are applied to trusts (as per section 1.28 of the explanatory materials) and welcomes the proposed changes set out in the draft legislation to clarify how hybrid mismatch rules operate for trusts. This is a step in the right direction.

Trust structures like MITs and AMITs provide important tax settings and help to attract investment to the property sector through investment vehicles like real estate investment trusts (REITs). The need for special rules and exceptions for REITs and other trusts within the context of the OECD's BEPS project was recognised in the OECD's Action 2 Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements.*

However, there are critical issues (namely the six issues listed below) not addressed by the draft legislation that should be considered to deal with the uncertainty and inequity that exists in applying hybrid mismatch rules for widely held property trusts to ensure the rules operate as intended. Without a legislative fix, Australian taxpayers investing through trusts may inadvertently be subject to double taxation on certain offshore investments. Offshore fund investors may also be subject to double taxation in relation to Australian investments contrary to the intention of the rules.

This will have an impact on the ability of Australia in continuing to build a world-class funds management sector (across both property and other asset classes) and our attractiveness as an investment destination.

If you would like to discuss any aspect of this submission, please contact Kosta Sinelnikov on 02 9033 1998 and ksinelnikov@propertycouncil.com.au, or myself on 0400 356 140 and bngo@propertycouncil.com.au.

Yours sincerely

Belinda Ngo
Executive Director, Capital Markets

Outstanding hybrid mismatch rules issues

We have identified six issues below that are not addressed by the draft legislation that require consideration to deal with the uncertainty and inequity that exists in applying hybrid mismatch rules for widely held trusts and to ensure the rules operate as intended:

1. Reduction of dual inclusion income to deny 'excess' FITOs – inequitable outcomes where Australian investors are subject to different rates of tax
2. Reduction of dual inclusion income for trusts with a mix of Australian and foreign investors – inequitable outcomes for Australian investors
3. Calculating dual inclusion income for widely held trusts – difficulties in determining whether an amount "reasonably represent" the amounts subject to Australian tax
4. Potential uncertainty in calculating dual inclusion income for trusts where assessable income is greater than net income
5. Inconsistent outcomes for loss trusts versus loss companies
6. Dual inclusion income group definition – Inability for foreign funds to access grouping

Issues 2, 3, 4 and 5 above relate to whether income or profits of a trust are "subject to Australian tax" in calculating dual inclusion income. We believe that Treasury should consider either or all of the following options to address unintended outcomes and to alleviate the compliance burden for widely held trusts:

a) repealing subsection 832-125(2) of the Income Tax Assessment Act 1997[1] in its entirety. Following the proposed change to subsection 832-30(4) in the draft legislation, Australian trusts will now be able to satisfy the primary limb of the "subject to Australian income tax" test in subsection 832-125(1), whereas previously such entities needed to satisfy the requirements of the second limb in subsection 832-125(2)[2];

b) modifying the rules to recognise that certain net income of an Australian trust will not be "subject to Australian tax" if it is foreign sourced (relevant for issue 3). The amendment may be effected by inserting:

   "s.832-680(2A) For the purposes of subsection (1), if:

   > *(a) an amount of assessable income of a trust or partnership would not, apart from this subsection, be *subject to Australian income tax; and*
   > *(b) the amount would be subject to Australian income tax if the assessable income was attributable to sources in Australia;*

   then the amount is treated as if it were subject to Australian income tax."

   A modification would also need to be made to s 832-680(2)(a) to add "or subsection (2A)" after "this subsection" to prevent the FITO interaction rule then applying to this deemed amount.

c) providing a concession or a more general, simplified and equitable method for widely held flow-through entities to calculate dual inclusion income.

[1] Please note that all references to sections of legislation refer to the *Income Tax Assessment Act 1997*.

[2] The proposed change in subsection 832-30(4) is welcomed as it addresses the technical issue that an Australian trust does not have assessable income for an income year, rather net income for an income year.

We would welcome the opportunity to engage with Treasury to discuss potential options to achieve this outcome. Recommendations to address the concerns in relation to issue 1 and 6 are also set out below.

1. Reduction of dual inclusion income to deny 'excess' FITOs – inequitable outcomes where Australian investors are subject to different rates of tax

The reduction of dual inclusion income to deny 'excess' FITOs pursuant to subsection 832-680(2) gives rise to inequitable outcomes and extreme practical difficulties in application, particularly in the context of widely held trusts.

Where an amount of assessable income of an entity would be "subject to Australian income tax" and a FITO is available for foreign tax paid, subsection 832-680(2) requires a reduction to dual inclusion income if the amount of the FITO equals or exceeds the amount of Australian tax that would be payable (having regard only to the assessable amount and the rate at which tax is imposed on the entity). The reduction to dual inclusion income results in additional assessable income under the foreign hybrid rules, intended to eliminate the 'excess' FITO. The following example illustrates the intended outcome:

Example 1 – Australian trust with superannuation fund investors investing in New Zealand real property

An Australian unit trust invests 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, and one assumes that the trust has prima facie dual inclusion income and deduction/deduction mismatches. An Australian superannuation fund with a tax rate of 15% holds 100% of the units in the Australian unit trust. Subsection 832-680(2) would operate as set out below.

		Australian tax 15%	Foreign tax 28%
Assessable	180.00		
Deductible	<u>-140.00</u>		
Prima facie taxable income	40.00	**6.00**	11.20
Mismatch	140.00		
Reduction*	<u>-105.33</u>		
Taxable income	**74.67**	11.20	
FITO		-11.20	
Tax payable		**0.00**	
*180.00 – (11.20/0.15)			

While the above is the intended policy outcomes, the policy is not achieved where there are multiple investors in an Australian trust and 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.

In this case, the increased net income distribution of the trust (due to the artificial reduction in dual inclusion income relating to investors on a lower rate of tax) is shared between all investors, based on the proportion of the income of the trust estate to which each investor is presently entitled.

In this situation the investors that have sufficient Australian tax payable to utilise the FITOs in full are 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 dual inclusion income 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.

Example 2 – Australian trust with a mix of Australian investors investing in New Zealand real property

As in Example 1, an Australian unit trust invests 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. One assumes that the trust has prima facie dual inclusion income and deduction/deduction mismatches. An Australian company (30% corporate tax rate) holds 50% of the units and an Australian superannuation fund (15% tax rate) holds the remaining 50% of the units in the Australian unit trust.

		Australian tax - superfund 15%	Australian tax - company 30%	Foreign tax 28%
Assessable	180.00			
Deductible	-140.00			
Prima facie taxable income	40.00	3.00	6.00	11.20
Mismatch	140.00			
Reduction*	-124.00			
Taxable income	**56.00**	4.20	8.40	
FITO		-5.60	-5.60	
Tax payable / (excess FITO)		**-1.40**	**2.80**	
*0.5 x (180.00 – (11.20/0.15)) + 0.5 x (180.00 – (11.20/0.30))				

In contrast to Example 1, the outcome in Example 2 is double taxation as the unit trust is denied a deduction due to the artificial reduction in dual inclusion income. The company investor is also not able to offset the increased net income distribution with the FITO.

In order to achieve what might be considered as the intended policy outcome as per the previous example, the taxable income of the superfund would need to be calculated and set at a different level relative to the taxable income of the company.[3] However, there are no means to achieve these outcomes under the hybrid mismatch rules through denying a deduction at the trust level as all beneficiaries will be affected due to the way in which investors in trusts are tax under Division 6. The "excess FITO" rules are therefore fundamentally flawed for trusts with multiple beneficiaries that are not all paying the same rate of tax.

From a practical perspective it is unclear how much of the foreign tax paid in respect of the underlying investments will count towards a FITO, 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.

[3] For example, the superfund's taxable income would need to be $37.33 and the taxable income of the company would need to be $20.00, as this would give the result that the tax payable by the superfund (15% x $37.33) equates to the $5.60 FITO and with the company paying an extra $0.40 ($6.00 tax less $5.60 FITO) or 2% of Australian tax on its $20 share of the trust's income representing the 2% differential of the domestic tax rate over the foreign tax rate.

Given the difficulties identified above, we are of the view that subsection 832-680(2) should not apply to deducting hybrids that are widely held collective investment vehicles, including:

- listed trusts;
- public unit trusts;
- managed investment trusts;
- attribution managed investment trusts;
- trusts that are a subsidiary of one or more of the above.

While such an exclusion would not mitigate double taxation 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 (if not impossible) to identify the tax rate and availability of FITOs of investors and it is more likely that there would be investors with a range of different tax rates.

As an alternative, Australian investors in widely held trusts should be deemed to be subject to Australian tax at a rate of 30%, reflecting the tax rate applying to the income of a majority of Australian individuals and company taxpayers.

2. Calculating dual inclusion income for widely held trusts – difficulties in determining whether an amount "reasonably represent" the amounts subject to Australian tax

Widely held trusts face significant challenges in seeking to fully comply with the hybrid mismatch rules in relation to the determination of dual inclusion income.

In order to calculate dual inclusion income, the trust needs to show that an amount was subject to Australian tax. Normally this simply means that the amount was included in the assessable income of the entity. However, trusts must show under s832-125(2) that the amount "reasonably represents" the amounts included in the assessable income of another entity that is not another trust or partnership. Ultimately this requires the first trust to trace through all interposed trust or partnership entities in the chain of ownership of interests.

These entities have to work through all of the implications of calculating dual inclusion income and understand how income flows through and to what extent foreign income tax offsets (FITOs) are available and utilised all the way through to the end of the chain of their unitholders. To precisely calculate dual inclusion income would be very costly and otherwise almost impossible for such widely held entities who do not have access to the information necessary to do so (as this would require tax returns for all their investors, then all the entities that receive distributions from their investors, and so on).

We believe that Treasury should consider repealing subsection 832-125(2) in its entirety or otherwise providing a concession or a more general, simplified method to assist widely held flow-through entities to calculate dual inclusion income and ease the compliance burden in applying these rules.

3. Reduction of dual inclusion income for trusts with a mix of Australian and foreign investors – inequitable outcomes for Australian investors

Another scenario is likely to result in an inequitable outcome for investors through the reduction of dual inclusion income when there is a mix of Australian and foreign investors in an Australian-domiciled entity.

Example 3 – Australian trust with a mix of Australian and foreign investors investing in New Zealand real property

An Australian unit trust invests 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. One assumes that the trust has prima facie dual inclusion income and deduction/deduction mismatches. An Australian company (30% corporate tax rate) holds 50% of the units and a foreign entity holds the remaining 50% of the units in the Australian unit trust. The foreign entity is not subject to Australian tax in relation to the income derived from the Australian unit trust as the net income of the trust is foreign sourced (being NZ sourced rental income).

		Australian tax - company 30%	Foreign company 0%	Foreign tax 28%
Assessable	180.00			
Deductible	-140.00			
Prima facie taxable income	40.00	6.00	N/A	11.20
Mismatch	140.00			
Reduction*	-90.00			
Taxable income	**90.00**	13.50	N/A	
FITO		-5.60	N/A	
Tax payable		**7.90**	**N/A**	

* Simplified example being 50% of the dual inclusion income ($180) that is subject to Australian tax (the remaining 50% not being subject to Australian tax as it foreign sourced). Example does not adjust for the foreign tax paid, which will reduce the reduction, thereby leading to greater taxable income.

This inequitable outcome for different investors is achieved because the foreign investor is not "subject to Australian tax" in relation to income derived from the Australian unit trust, although this is a feature or design of Australia's tax rules.[4] Moreover, the impact of the reduction in dual inclusion income is to primarily penalise the Australian investor, rather than the foreign investor. No such impact arises where an Australian company or foreign investor is the sole investor in the Australian unit trust.

Such a contradictory outcome is likely to discourage the pooling of assets among different investor types, which runs counter to the policy objectives of enabling Australia to become an efficient and sophisticated investment hub that can attract foreign and domestic capital to invest both locally in Australia and offshore.

We believe that Treasury should consider either or all of the following options:

a) repealing subsection 832-125(2) in its entirety (refer to the rationale outlined above);

b) modifying the rules to recognise that certain net income of an Australian trust will not be "subject to Australian tax" if it is foreign sourced (relevant for issue 3). The amendment may be effected by inserting:

"s.832-680(2A) For the purposes of subsection (1), if:

[4] Pursuant to subsection 832-560(2), an amount of dual inclusion income is available to be applied to reduce the neutralising amount for a deducting hybrid mismatch if the amount is "subject to Australian income tax" and "subject to foreign income" in the foreign country in which the foreign income tax deduction arose. Pursuant to subsection 832-125, "subject to Australian income tax" requires that the net income of the Australian unit trust is included in the assessable income of an ultimate beneficiary that is not a trust or partnership.

*(a) an amount of assessable income of a trust or partnership would not, apart from this subsection, be *subject to Australian income tax; and*
(b) the amount would be subject to Australian income tax if the assessable income was attributable to sources in Australia;

then the amount is treated as if it were subject to Australian income tax."

A modification would also need to be made to s 832-680(2)(a) to add "or subsection (2A)" after "this subsection" to prevent the FITO interaction rule then applying to this deemed amount.

c) providing a concession or a more general, simplified and equitable method for widely held flow-through entities to calculate dual inclusion income. To rectify this particular issue, it would also be necessary to amend section 832-560 so as to allow, in the dual inclusion amount, an amount that has been subject to foreign income tax in any foreign country (rather than only the foreign country in which the foreign income tax deduction arose).

4. Potential uncertainty in calculating dual inclusion income for trusts where assessable income is greater than net income

Other difficulties are often encountered when calculating dual inclusion income for flow-through trusts.

One concern is with the "reasonably represents" requirement when there are deductions to reduce the net amount that flows through. For example, if a trust has $1,000,000 that is assessed in two countries, but its net income for the year happens to be $1 which is assessable to an individual, the question arises of whether only $1 is considered to be dual inclusion income because that is the only amount that is assessable to another entity. Alternatively, the $1 can reasonably represent the entire $1,000,000 assessable to the trust by looking at the items that made up the $1 (i.e. both the income and the deductions).

If this approach is applied to a similar set of circumstances as in Example 1 illustrated above, then the intended policy outcomes are not achieved even in a basic case with a single beneficiary.

Example 4 – Australian trust with assessable income greater than net income

The amount subject to Australian income tax (prior to any reduction and not taking into account the impact of FITOs) is only the net $40 amount that is assessable in its hands. The Australian tax that would be payable on this amount ($6.00) is less than the FITO ($11.20) such that no amount will be considered to be subject to Australian income tax in accordance with s 832-860(2)(c).

		Australian tax 15%	Foreign tax 28%
Assessable	180.00		
Deductible	-140.00		
Prima facie taxable income	40.00	**6.00**	11.20
Mismatch	140.00		
Reduction*	0.00		
Taxable income	**180.00**	27.00	
FITO		-11.20	
Tax payable		**25.80**	

*40.00 – (11.20/0.15) (cannot be less than nil, no amount considered to be subject to Australian income tax as the $11.20 FITO exceeds the tax payable on the $40 of prima facie taxable income)

This potential interpretation of the rules results in this incongruous outcome due to the way in which investors in a trust or partnership are subject to tax, being the inclusion of a share of the "net income" of the trust or partnership in the investor's assessable income.

To clarify the operation of the rules to investors in trusts, some of the options outlined above should be considered, namely:

a) repealing subsection 832-125(2) in its entirety; or

b) providing a concession or a more general, simplified and equitable method for widely held flow-through entities to calculate dual inclusion income.

5. Inconsistent outcomes for loss trusts versus loss companies

Another concern is the starkly different outcomes for loss entities. If a trust had $0 of net income, then the full amount of assessable income (e.g. $1,000,000) could be considered to be dual inclusion income because the requirement to trace through is only necessary where the trust has net income for the year. However, if a trust with net income distributes to a loss trust, then they appear to be disadvantaged because s832-125(2) requires another entity that is not a trust or partnership to include the amount in assessable income for an amount to be considered as dual inclusion income. If the trust instead distributed its net income (e.g. $1,000,000) to a loss company, then the company would include the distribution in its assessable income as it is not a trust or partnership. There appears to be no underlying policy rationale for why there are different results where the beneficiary of the trust is a loss company (i.e. full amount is considered subject to Australian income tax) as opposed to a loss trust (i.e. no amount is considered subject to Australian income tax).

Although we believe that s 832-125(2) should be repealed in its entirety as per our comments above, at the very least s 832-125(2)(c) should be modified so that the reference to another entity "(other than an entity that is a partnership or the trustee of a trust)" is changed to "(other than an entity that is a partnership or a trust *that has net income for the income year*)".

This would 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 and would still require tracing through the ultimate recipient in the chain where the first recipient does have net income (i.e. the tracing of distributions can end at a loss entity, regardless of the type of entity that it is).

6. Dual inclusion income group definition – Inability for foreign funds to access grouping

Currently there is uncertainty as to whether transparent collective investment vehicles with multiple investors can, as "liable entities", access dual inclusion income grouping in subsection 832-680(7) and the on-payment rule in subsection 832-680(5).

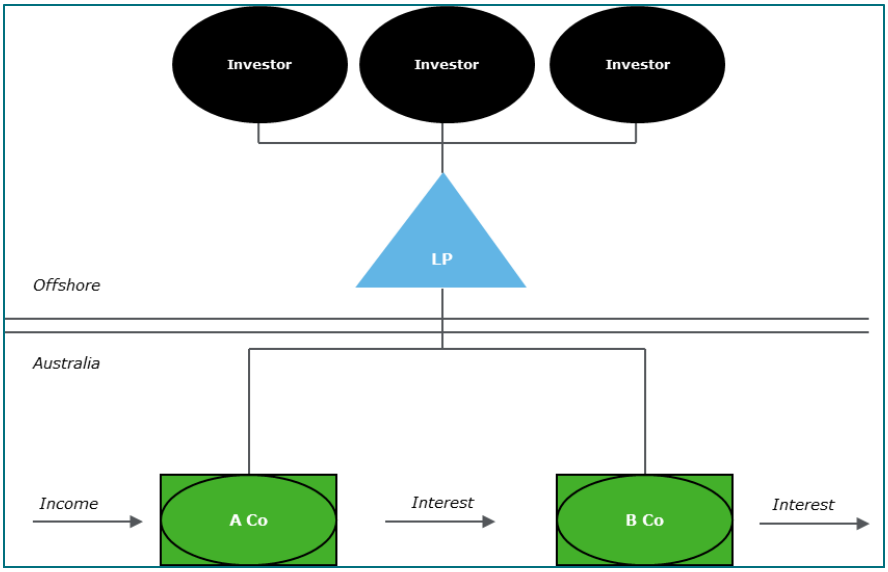
Subsection 832-680(6) should be amended to clarify that a dual inclusion income group exists to the extent that there are one or more liable entities in respect of the collective pool of income and profits of an entity.

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.*

On one view subsection 832-680(6) can only apply to treat a single liable entity and its wholly-owned subsidiaries as members of a dual inclusion income group. Applying this interpretation, where a transparent inbound collective investment vehicle invests directly in a number of Australian investee companies that are disregarded, there is no ability to apply dual inclusion income of one investee company against a hybrid payer or deducting hybrid mismatch arising in relation to the other investee company. The results are particularly inequitable where the relevant income arises from transactions between the investee companies, as in the case of a financing entity.

> *Example 5 – Inbound investor with financing entity*
>
> A collective investment vehicle that is established as a foreign limited partnership 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.



B Co interest payments give rise to 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 partnership net income. The income derived by A Co is dual inclusion income under subsection 832-680(1) but B Co is not eligible to apply the dual inclusion income unless A Co and B Co are members of a dual inclusion income group. The interest income to B Co is not dual inclusion income as it is disregarded for US tax purposes.

Subsection 832-680(6) should be amended to clarify that a dual inclusion income group is able to exist to the extent that there are one or more liable entities in respect of the collective pool of income and profits of an entity.

Such a clarifying amendment would address the issue in Example 5 above, as A Co would be eligible to apply the dual inclusion income of B Co pursuant to subsection 832-680(7).