



Australian Government

The Board of Taxation

IMPLEMENTATION OF THE OECD ANTI-HYBRID RULES

Consultation paper

the **board** of  **taxation**
www.taxboard.gov.au

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FOREWORD

INTRODUCTION

As part of the 2015 Budget, on 12 May 2015 the Treasurer wrote to the Board of Taxation to ask it to consult on implementation of anti-hybrid rules developed by the Organisation for Economic Cooperation and Development (OECD) under Action Item 2 of the [Base Erosion and Profit Shifting \(BEPS\) Action Plan](#).

The OECD report entitled '[Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report](#)' (**Action 2 Report**) was released on 5 October 2015.

The terms of reference for this review were given to the Board on 14 July 2015 and are attached at Appendix A. The Board is asked to report on the Australian implementation considerations arising from the recommendations included in the Action 2 Report. The Board is asked in particular to identify an implementation strategy that has regard to:

1. Delivering on the objectives of eliminating double non-taxation, including long term tax deferral;
2. Economic costs for Australia;
3. Compliance costs for taxpayers; and
4. Interactions between Australia's domestic legislation (for example, the debt-equity rules and regulated capital requirements for banks), international obligations (including tax treaties) and the new anti-hybrid rules.

The Board's review will focus, at a high level, on identifying the major implementation considerations involved and making a recommendation as to the appropriate timing for implementation of these rules. The Board is asked to report by the end of March 2016.

Australia is one of many countries considering the Action 2 Report recommendations and related implementation issues.

REVIEW TEAM

The Board has appointed Karen Payne to oversee the review. The Board also appointed an Expert Panel, namely Chris Vanderkley, Grant Wardell-Johnson, Mark Ferrier and Michael Fenner to provide further specialist assistance to the Board.

The Working Group has been assisted by members of the Board's Secretariat and by staff from the Treasury and from the ATO.

CONSULTATION PROCESS

In conducting this review, the Board proposes to consult widely and provide all stakeholders with the opportunity to participate in the review. To facilitate the public consultation process, the Board has developed this paper as a basis for further discussions. In developing this paper, the Board held targeted preliminary consultation meetings with stakeholders (including Treasury and the ATO) in Sydney and Melbourne.

The Board welcomes submissions on the issues raised in this paper by 15 January 2016, to enable the Board to finalise its report in the timeframe requested by the Government. Submissions need not respond to all questions raised. Questions highlighted in bold are considered key questions and the Board requests particular focus on these areas. Stakeholders are also welcome to provide oral submissions.

The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. The Board's report and its recommendations will reflect the Board's independent judgement.

Submissions should be sent:

By email to:

hybrids@taxboard.gov.au

By post to:

Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Stakeholders making submissions should note that Board members, the review team, and those assisting the review, will have access to all submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board's website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.



Michael Andrew
Chair, Board of Taxation



Karen Payne
Chair of the Board's Working Group
Member, Board of Taxation

CHAPTER 1: BACKGROUND AND OVERVIEW

BACKGROUND TO THE IMPLEMENTATION REVIEW

- 1.1 The OECD report entitled 'Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report' (Action 2 Report) was released on 5 October 2015 and is part of the 'Base Erosion and Profit Shifting (BEPS) Action Plan' developed by the OECD to address BEPS in a co-ordinated and comprehensive manner.
- 1.2 The Action Plan and Action 2 Report were developed as part of the G20's agenda, which followed extensive consultation with G20 and OECD member countries as well as developing nations.
- 1.3 The Action 2 Report calls for the development of model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities.¹ In this context, 'hybrid mismatch arrangements' are arrangements that 'exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.'²

OVERVIEW

- 1.4 The principal objective of the Action 2 Report recommendations is to neutralise the effects of hybrid mismatches to discourage uncompetitive arrangements (that is, ensure unfair tax advantages do not accrue for multi-national groups as compared with domestic groups). The Action 2 Report concludes that hybrid mismatch arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned, with an overall negative impact on competition, efficiency, transparency and fairness.² The OECD and G20 considered this approach to be the only comprehensive and coherent way to tackle global tax avoidance and to discourage uncompetitive arbitrage.
- 1.5 Action 2 Report recommends that arrangements be neutralised as follows:
 - Where there is a deduction/no inclusion outcome (D/Ni) - deny the payer the deduction (primary response) or require the inclusion of the income (secondary response).³
 - Where there is a double deduction (DD) outcome for a single expenditure - deny the deduction in the parent jurisdiction.⁴

1 BEPS Action 2: 2015 final report: paragraph 3 on page 15.

2 BEPS Action 2: 2015 final report: Executive Summary.

3 Refer to recommendation 1 - hybrid financial instruments rule, 3 - disregarded hybrid payments rule, 4 - reverse hybrid rule and 8 - imported mismatch rule.

- 1.6 Specific recommendations apply under recommendation 2 to restrict dividend exemptions or foreign tax credit relief, and recommendation 5 to specifically address reverse hybrid arrangements. Imported mismatch arrangements that circumvent the other anti-hybrid rules are addressed in recommendation 8.

The OECD process

- 1.7 Australia has played an integral role in leading the G20 agenda and contributing to the OECD's work on addressing BEPS.
- 1.8 The OECD in its Explanatory Statement on the 2015 Reports indicated that, in respect to hybrid mismatch arrangements, countries have agreed a general tax policy direction. This means that countries are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future.

The Australian Context

- 1.9 The Australian Government is committed to eliminate, in partnership with the OECD and through the G20, the tax advantage arising from the use of hybrid instruments and entities whilst ensuring investment activity is not compromised and that Australia remains an economically competitive place to do business.
- 1.10 Australia already has comprehensive rules to address a number of the BEPS measures. However, Australia's domestic tax law does not generally take account of the tax treatment of a financial instrument, arrangement or entity in another jurisdiction, which can give rise to hybrid mismatches. As such, unlike some of the other BEPS Action Plans, Australian tax laws do not currently meet the OECD recommendations to address hybrid mismatches in Action Plan 2.
- 1.11 There is a strong expectation in the international community that Australia will adopt Action 2 recommendations in a harmonised way with the international community and in full. A number of other countries have unilaterally implemented financial instrument anti-hybrid rules prior to the release of the Action 2 Report,⁵ and are considering what amendments are needed to reflect the full suite of OECD recommendations. The United Kingdom announced on 5 October 2014 its commitment to implement the Action 2 recommendations with a start date of on or after 1 January 2017.⁶ Australia is monitoring the progress of other countries in relation to these matters.

4 Refer to recommendations 6 – deductible hybrid payments rule and 7 – dual resident payer rule.

5 Including Japan and a number of EU countries.

6 The UK has existing anti-hybrid rules which it intends to revise to adopt the OECD recommendations.

CHAPTER 2: KEY IMPLEMENTATION ISSUES

COSTS AND BENEFITS OF IMPLEMENTING THE ANTI-HYBRID RULES

- 2.1 It is important to identify and balance the potential costs and benefits associated with various options in making any recommendation as to when and how Australia should implement the OECD recommended anti-hybrid rules.

Consultation questions

The Board invites comments from stakeholders on the following:

- Q1. What are the advantages and disadvantages (economic, commercial, revenue or other) for Australia in implementing the anti-hybrid rules as recommended in the Action 2 Report?**
- Q2. What are the key implementation costs, obstacles and material compliance costs for taxpayers, the ATO and Government if the anti-hybrid rules as recommended in the Action 2 Report were implemented by Australia?

INTERACTION WITH AUSTRALIA'S TAX LAWS

- 2.2 There are a number of operational and integrity measures in the domestic tax law that already apply specifically to financial instruments (for example, the debt/equity classification, Taxation of Financial Arrangements, thin capitalisation, withholding tax and transfer pricing). In addition, Australia has comprehensive integrity rules to address aggressive tax planning strategies. These include thin capitalisation rules, Controlled Foreign Company (CFC) rules, Part IVA and the proposed Multinational Anti-Avoidance Law.
- 2.3 Care will need to be taken to minimise any practical and legislative challenges that may arise from the interaction between new anti-hybrid rules and relevant domestic and international tax laws.

Consultation questions

The Board invites comments from stakeholders on the following:

- Q3. Whether there are any aspects of the Action 2 Report that should not be implemented on the basis that Australia's laws are sufficiently comprehensive?**

Consultation questions (continued)

- Q4. How should the anti-hybrid rules interact operationally with other parts of the Australian tax law?
- (a) Should the anti-hybrid rules apply in priority to all other parts of the Australian tax law by virtue of an ordering rule? If so, should there be any exceptions?
 - (b) Are there likely to be any interactions which give rise to unintended or inappropriate outcomes?
 - (c) Should the anti-hybrid rules be incorporated as amendments to specific areas of the existing tax law (such as, for example, the debt/equity rules) or sit as a separate, overarching code?
 - (d) How should the anti-hybrid rules interact with Australia's double tax treaties?

INTERACTION WITH OTHER OECD BEPS ACTION ITEMS

- 2.4 The anti-hybrid rules will interact with certain BEPS action items, including CFC rules (action item 3); interest limitation rule (action item 4); and preventing treaty shopping (action item 6).⁷
- 2.5 In light of this, any coordination between relevant BEPS action items and the anti-hybrid rules should be done in a way that minimises duplication, inconsistency and complexity in complying with the rules.

Consultation questions

- Q5. The Board invites comments from stakeholders on whether and if so the circumstances under which the anti-hybrid rules are likely to:
- (a) duplicate, or be inconsistent with, the operation of BEPS action items 3, 4 and 6; and
 - (b) interact with other BEPS action items with adverse or unintended consequences for taxpayers (if any).

⁷ BEPS Action 2: 2015 final report: reverse hybrid rule and controlled foreign companies (example 4.3); design principles and the interest limitation rule (example 9.2); and the interaction between part 1 and tax treaties (chapter 15).

IMPLEMENTATION TIMING AND TRANSITIONAL ISSUES

- 2.6 The Action 2 Report does not prescribe a date by which countries should implement its recommendations.
- 2.7 In an Australian context, a number of factors may be relevant to determining an appropriate application date, including the timing of actions being taken by our major trading partners. The UK is the only country that has announced publicly that it will implement OECD compliant anti-hybrid rules and indicated an intended start date, being on or after 1 January 2017.
- 2.8 Concerns have been raised in preliminary consultations that Australia should not be seeking to implement the recommendations ahead of other key jurisdictions. On the other hand, even if Australia defers the recommendations relative to other countries, it may in the interim be affected by the recommendations due to the linking between the primary and defensive rules. Therefore, there may be benefit in harmonising adoption of the recommendations with other key jurisdictions.
- 2.9 Comments are also sought on whether pre-existing structures and instruments issued prior to the start date of the anti-hybrid rules should be grandfathered. The Action 2 Report discourages grandfathering of arrangements, but concerns have been raised that taxpayers locked into long term arrangements may be disadvantaged. However, grandfathering may not be effective where other countries do not grandfather pre-existing arrangements, as the operation of their defensive rules may eliminate any hybrid mismatch.
- 2.10 Where pre-existing structures and instruments are not grandfathered, the Action 2 Report suggests that an appropriate transition period may be necessary to allow for taxpayers to restructure their arrangements.

Consultation questions

The Board invites comments from stakeholders on the following:

- Q6. What is an appropriate commencement date for the anti-hybrid rules? For example, 1 July 2017 or later?**
- Q7. Should Australia harmonise the commencement date for some or all of the anti-hybrid rules? If so, which countries or categories of countries should Australia look to harmonise with?
- Q8. What is an appropriate transition period and transitional arrangements into the anti-hybrid rules?**
- Q9. Whether pre-existing structures and instruments issued prior to the start date of the anti-hybrid rules should be grandfathered? What are the integrity concerns for grandfathering?**
- Q10. Whether the unwinding of hybrid arrangements could give rise to adverse tax, legal and/or commercial consequences.

CHAPTER 3: SCOPE OF THE OECD ANTI-HYBRID RULE

- 3.1 Part I of the report sets out recommendations for domestic law rules to address mismatches in tax outcomes for payments made under a hybrid financial instrument or payments made to, or by, a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch are imported into a third jurisdiction. The rules are designed to apply automatically (without regard to purpose) and are ordered in the form of a primary and secondary or defensive rule. This is intended to avoid double taxation by preventing more than one country applying the rule to the same arrangement.
- 3.2 The recommended primary rule is for countries to deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable ordinary income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.
- 3.3 The Action 2 Report also contains specific recommendations (see recommendation 2 and recommendation 5) which are improvements that could be made by countries in their domestic law that will reduce the frequency of hybrid mismatches arising. In this respect, assuming countries implement the full suite of the OECD recommendations, these specific recommendations should reduce the need for counterparty jurisdictions to apply the primary rules of the other anti-hybrid recommendations.
- 3.4 Part II of the report addresses the international law aspects, making recommendations to ensure that dual resident entities and tax treaties are not used to prevent the application of changes to the domestic law recommended in Part I of the report.
- 3.5 The hybrid mismatch rules are intended to be introduced by all jurisdictions so that the same rules will be applied to each of the affected jurisdictions, but can still operate effectively regardless of whether introduction is universal. Consistent rules allow the outcome in one jurisdiction to be linked to the outcome in another, minimising the risk of both double taxation and double non-taxation.

CHAPTER 4: SUMMARY OF THE OECD ANTI-HYBRID RECOMMENDATIONS

4.1 The Action 2 Report includes 12 recommendations (1 – 12). There is a Chapter which corresponds to each Recommendation (1 -12) followed by Chapters 13, 14, and 15 which deal with Treaty Issues.

4.2 The table below provides a summary of the anti-hybrid rules which include a recommendation to neutralise anti- hybrid mismatches.

Recommendation	Neutralising recommendation	Scope
Deduction / No Inclusion (D/Ni) outcomes		
1. Hybrid financial instrument	Primary rule – Deny payer deduction to the extent of the D/Ni outcome Defensive rule – Include in payee ordinary income to the extent of the D/Ni outcome	Related persons and structured arrangements
2. Specific Hybrid financial instrument rule	Deny dividend exemption for deductible payments Limits withholding tax relief for hybrid transfer instruments	No scope limitation
3. Disregarded Hybrid Payments Rule	Primary rule – Deny payer deduction ⁸ Defensive rule – Include in payee ordinary income	Same control group and structured arrangements
4. Reverse Hybrid Rule	Primary rule – Deny payer deduction.	Same control group and structured arrangements
5. Specific Reverse Hybrid Rule	Specific recommendations to: - Improve CFC rules/offshore investment regimes - Limit tax transparency for non-resident investors - Introduce information reporting for intermediaries	No scope limitation
Deduction / Deduction (or Double Deduction DD) outcomes		
6. Deductible Hybrid Payment Rule	Primary rule – deny parent entity deduction Defensive rule – deny payer deduction	Defensive rule applies to same control group and structured arrangements
7. Dual Resident Payer Rule	Primary rule – deny parent entity deduction There is no defensive rule	No scope limitation
Indirect Deduction / No Inclusion D/Ni outcomes		
8. Imported Mismatch rule	Primary rule – Deny payer deduction	Same control group and structured arrangements

⁸ To the extent it exceeds dual inclusion income (where the income is recognised in more than one jurisdiction - may include CFC income).

RECOMMENDATION 1 – HYBRID FINANCIAL INSTRUMENTS RULE

- 4.3 Recommendation 1 is set out in Chapter 1 of the Action 2 Report and is illustrated by examples 1.1 – 1.37 (refer especially to examples 1.1, 1.5, 1.6, 1.7, 1.13, 1.14, 1.17, 1.23 and 1.24).
- 4.4 Recommendation 1 applies to three different types of financing arrangements that give rise to a hybrid mismatch:
1. **Financial instruments** – this covers arrangements that are treated as debt, equity or derivative contracts. An example is a redeemable preference share issued by an Australian company which is treated as debt for Australian tax purposes and equity in the jurisdiction of the holder.
 2. **Hybrid transfers** – this applies where entities in different jurisdictions are treated as the owner of the same asset for tax purposes. An example could be a securities lending arrangement where one jurisdiction treats the legal owner as the holder of the securities and another jurisdiction treats the economic owner as the holder of the securities.
 3. **Substitute payments** – this covers where a payment is made in substitution for the financing or equity return on a transferred asset where the tax outcome undermines the integrity of the hybrid financial instrument rule.
- 4.5 A payment under a financial instrument will only result in a hybrid mismatch where the mismatch can be attributed to the terms of the instrument. It does not have regard to status of the taxpayer or circumstances in which the instrument is held. For example, the rule is not intended to apply to payments to tax exempt pension funds solely because of that entity's tax exempt status. However, the rule can still apply to a hybrid financial instrument issued to a tax exempt pension fund where a D/Ni outcome arises due to the terms of the financial instrument and the general tax treatment of returns on that type of financial instrument in the payee and investor jurisdiction (regardless of the fact the income is also exempt due to the tax status of the pension fund). See specifically example 1.5 in the Action 2 Report.
- 4.6 Likewise, a mismatch that arises in respect of a payment made to a taxpayer in a purely territorial regime⁹ will not be caught by the hybrid financial instrument rule because the mismatch in tax outcomes will be attributable to the nature of the payer (as a non-resident payer of foreign source income) rather than to the terms of the instrument itself.
- 4.7 Although timing differences should not generally be subject to the hybrid financial instrument rules, certain deferred payments can be subject to recommendation 1. The Action 2 Report recognises this can give rise to

⁹ A jurisdiction that excludes or exempts all foreign source income

difficulties in determining whether or not a mismatch is one of timing. For example, interest that is deductible on an accruals basis in the payer jurisdiction but assessable on a paid basis in the payee jurisdiction may be caught. The OECD recommends a safe harbour period of 12 months from the end of the payer's accounting period. Otherwise, it must be established that the payment will be included in ordinary income within a 'reasonable period of time' (which has not been defined). The UK is considering a 5 year deferral period for hybrid timing differences.¹⁰

- 4.8 Payments will be treated as included in ordinary income if the payee jurisdiction taxes the payment at the taxpayer's full marginal rate. Ordinary income can also include income attributed under a CFC regime. Issues that arise relating to partial inclusions in attributable income are discussed further in this discussion paper under recommendation 5.

RECOMMENDATION 2 – SPECIFIC RECOMMENDATIONS FOR THE TAX TREATMENT OF FINANCIAL INSTRUMENTS

- 4.9 Recommendation 2 is set out in Chapter 2 of the Action 2 Report and is illustrated by examples 2.1 – 2.3 (refer especially examples 2.1 and 2.3).
- 4.10 The recommendation applies to a dividend exemption or equivalent tax relief.¹¹ However, there is otherwise no limitation on the scope of the rule. It can apply to any arrangement and not just structured arrangements or arrangements entered into between related parties.
- 4.11 Recommendation 2.1 applies to deny the payee a dividend exemption or equivalent tax relief to the extent the payment is deductible to the payer. Where recommendation 2.1 is adopted by the payee jurisdiction (such that the payee is denied a dividend exemption), it should not be necessary for the payer jurisdiction to then apply recommendation 1 to deny a deduction, as any mismatch will have already been eliminated.
- 4.12 Recommendation 2.2 sets out a rule to restrict foreign tax credits under a hybrid transfer, to align the availability of withholding tax relief with the economic benefit of the payment. This could arise under a securities lending arrangement where both the borrower and lender are treated as deriving the dividend income under their respective jurisdictions and both parties seek to claim withholding tax relief. The rule would operate to restrict the amount of credit in proportion to the net taxable income of the payer under the arrangement.

10 As noted in the UK's public consultation paper 'Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements' released December 2014.

11 Equivalent tax relief may include domestic tax credits, foreign tax credits or dividends taxed at a reduced rate.

- 4.13 Recommendation 2 is optional for countries to adopt. Australia will need to consider whether to apply this recommendation to our existing dividend exemption in Subdivision 768-A of the 1997 Act. It is expected that most countries that provide a dividend exemption or equivalent tax relief will adopt recommendation 2. As noted above, a number of countries (for example the UK, Japan and the Netherlands) have either already enacted, or have announced that they will enact, a similar rule to recommendation 2 in their domestic tax law.

Consultation questions

The Board invites comments from stakeholders on the following:

- Q11.** The term ‘financial instrument’ is defined in recommendation 1 of the Action 2 Report. Is this definition sufficient or does it need to be modified? For example, are there other definitions in the Australian tax law that could be used or adapted (such as, for example, the ‘financial arrangement’ definition in Division 230)?
- Q12.** Should cross-border lease transactions be included in recommendation 1? Are there particular types of leases that should be specifically included or excluded?
- Q13.** With regard to hybrid financial instrument timing differences, what should be considered a ‘reasonable period of time’ for deferral? For example, should it be 1 year, 3 years, 5 years, or some other period? What considerations other than the length of time held (such as the nature of the financial instrument) should be taken into account?
- Q14.** To the extent a tax deduction is denied under recommendation 1, should Australia still seek to apply interest withholding tax to the payment?
- Q15.** Is there any reason why Australia should not adopt recommendation 2.1 or 2.2 in full? For recommendation 2.1, should franking credits be included as ‘equivalent tax relief’?

RECOMMENDATION 3 – DISREGARDED HYBRID PAYMENTS RULE

- 4.14 Recommendation 3 is set out in Chapter 3 of the Action 2 Report and is illustrated by examples 3.1 and 3.2.
- 4.15 Recommendation 3 focuses on payments made by a hybrid payer.

- 4.16 A hybrid payer is any entity which makes a payment where the tax treatment under the laws of the payee jurisdiction causes the deductible payment¹² to be a disregarded payment. Payments which are disregarded only give rise to a hybrid-mismatch where they are available to set off an amount of income that is not recognised in both the payer and payee jurisdiction. There is no hybrid mismatch where the deduction offsets dual inclusion income – that is, income included in the income in both the payer and payee jurisdiction.
- 4.17 An example of where a disregarded hybrid payment could arise in the Australian context is where an Australian limited partnership (ALP), which is treated as a company for Australian tax purposes and is a head company of an Australia tax consolidated group, borrows funds from one of the partners and claims a deduction for the interest payments (which can offset the income of other members in the Australian tax consolidated group). The partners of the ALP are resident in a jurisdiction that treats the ALP as transparent, such that the interest income and interest expense is not recognised in the payee jurisdiction (disregarded payment). This example is shown diagrammatically at Appendix B.
- 4.18 Any amount disallowed can be carried forward to be set off against dual inclusion income in another period. The report allows Australia flexibility to consider whether a simpler implementation solution could be adopted for tracking items of dual inclusion income.
- 4.19 Concerns have been raised in preliminary consultations that ordinary branch transactions with no hybrid purpose could be caught within the rules and face a significant compliance burden to identify and neutralise unintended mismatches.

RECOMMENDATION 4 – REVERSE HYBRID RULE

- 4.20 Recommendation 4 is set out in Chapter 4 of the Action 2 Report and is illustrated by examples 4.1 – 4.4 (refer especially to example 4.3).
- 4.21 A deductible payment made to a reverse hybrid may give rise to a mismatch in tax outcomes where that payment¹³ is not included in ordinary income in the jurisdiction where the payee is established or in the jurisdiction of any investor in that payee. Recommendation 4 requires the denial of a deduction to the payer.
- 4.22 A reverse hybrid is any entity (such as a partnership) that is treated as transparent in the jurisdiction in which it is established, but treated as a separate opaque (taxable entity) by the investor jurisdiction (in the case of a partnership, this may be where the partners are tax resident). This type of entity is referred to as a reverse hybrid as it is the reverse of the more usual type of hybrid (where the

12 Deductible payments are not limited to interest payments and may include items such as rent, royalties and services payments.

13 Like the disregarded hybrid payments rule, the reverse hybrid rule applies to a broad range of deductible payments (but does not include capital allowances) – see footnote 12.

establishment jurisdiction treats the entity as opaque and the investor jurisdiction treats the entity as transparent).

- 4.23 An example of a reverse hybrid entity in the Australian outbound context could arise where an Australian resident company owns, say, 25 per cent of the shares in New Zealand (NZ) Limited Partnership (LP). On the assumption that the NZ LP is not a CFC and the current domestic foreign hybrid rules¹⁴ do not apply, Australia will treat the NZ LP as opaque, whereas the NZ LP will be treated as transparent in NZ.
- 4.24 The reverse hybrid rule does not apply where a mismatch would not have arisen had the income been paid directly to the investor.

RECOMMENDATION 5 – SPECIFIC RECOMMENDATIONS FOR THE TAX TREATMENT OF REVERSE HYBRIDS

- 4.25 Recommendation 5 is set out in Chapter 5 of the Action 2 Report. There are no examples in the Action 2 Report for this recommendation.
- 4.26 Recommendation 5 sets out improvements that could be made to reduce the incidence of reverse hybrids, namely:
- (a) **amend the offshore investment (CFC) rules** to ensure attribution of any ordinary income allocated to the taxpayer by a reverse hybrid (to eliminate any NI outcome). Australia will need to determine whether and how its CFC rules should be amended to reflect this recommendation;
 - (b) **‘switch off’ tax transparent treatment in the establishment jurisdiction** (by treating the tax transparent vehicle as a resident taxpayer) where a tax transparent vehicle is controlled by a non-resident investor who will not be subject to tax on income allocated to that investor by the tax transparent vehicle (because it is not transparent in the investor’s jurisdiction); and
 - (c) **introduce tax filing and information reporting** to encourage appropriate and accurate records for tax transparent entities – that is, who their investors are, the size of each investor’s investment and the amount of income and expenditure allocated to each investor.
- 4.27 Where recommendation 5 is adopted by a jurisdiction, it may not be necessary for the payer jurisdiction to then apply recommendation 4 to deny a deduction as the mismatch has already been eliminated. Recommendation 5 applies in priority to the primary rule in recommendation 4.

14 See Division 830 of the 1997 Act. It is assumed in this example that the Australian investor has not made an election to treat the NZ LP as transparent (noting that the Australian investor only holds 25 per cent and therefore the foreign hybrid partnership rules are not automatically triggered).

- 4.28 A question was raised during consultation regarding whether the ‘to the extent’ requirement in the anti-hybrid rules extends to amounts of attributable income of a CFC that is included in a taxpayer’s ordinary income. For example, it was suggested in consultation that the Action 2 Report is unclear as to whether an amount of attributable income of a CFC will be considered to have been included in the ordinary income of that taxpayer (and subject to full marginal tax rates) where the CFC rules only require a certain percentage of attributable income to be included. An example provided was the UK CFC regime which allows a partial exemption for group finance companies and only brings 25 per cent of certain types of attributable income of a group finance CFC to tax in the UK. The rules are unclear whether this requires the outcome to be apportioned. This is also an issue for recommendation 1.

Consultation questions

The Board invites comments from stakeholders on the following:

- Q16.** Can you provide examples of hybrid entity and reverse hybrid structures that are commonly used in Australia?
- Q17.** Are there any concerns that recommendation 4 may give rise to inadvertent outcomes or a significant compliance burden for ordinary branch transactions? If so, please provide examples where issues may arise.
- Q18.** Whether, and to what extent, there are compliance challenges arising from identifying and quantifying the dual inclusion income and expenses? How could that evidence be obtained?
- Q19.** Can you suggest any simple implementation solutions that could be adopted in Australia to track items of dual inclusion income and D/NI or DD outcomes?
- Q20.** Are there any other concerns that arise from the adoption of recommendation 4?
- Q21.** Should Australia adopt the special rule in recommendation 5 to amend the CFC rules, limit the tax transparency for non-resident investors and require information reporting for intermediaries? If changes to the Australian CFC rules are adopted, do you foresee any particular compliance challenges?
- Q22.** Should CFC income included in ordinary income be subject to proportionality where the full amount of attributable income is not brought to tax? If so, how can this approach be developed to reduce complexity?
- Q23.** To reduce the compliance burden, should Australia consider any materiality thresholds that a taxpayer must meet before a CFC inclusion can be treated as reducing the amount of adjustment required under the rules?

RECOMMENDATION 6 – DEDUCTIBLE HYBRID PAYMENTS RULE

- 4.29 Recommendation 6 is set out in Chapter 6 of the Action 2 Report and is illustrated by examples 6.1 – 6.5 (refer especially to examples 6.3 and 6.5).
- 4.30 DD outcomes may be triggered where a taxpayer makes a payment through a cross-border structure, such as a dual resident, a foreign branch or a hybrid person, and a deduction can be claimed for that expenditure in more than one jurisdiction. Recommendation 6 will only apply where there is a hybrid mismatch, so will not apply where there is also dual inclusion income offsetting the DD (income included as assessable in more than one jurisdiction).
- 4.31 An example is a US general partnership (GP) with Australian partners that is treated as opaque in the US (under the ‘check the box’ regime) and treated as transparent in Australia. The US GP is the top company of a US tax consolidated group and borrows funds from a third party lender and claims a deduction for the interest both in the US at the GP level and again at the Australian partner level. This example is shown diagrammatically at Appendix B.
- 4.32 The OECD acknowledges that determining which payments give rise to a DD and which items are dual inclusion income requires a comparison between the domestic tax treatment of these items and their treatment under the laws of the other jurisdiction. The Action 2 Report notes countries should decide whether they extend recommendations 6 and 7 (see below) to all deductible items regardless of whether they are attributable to a payment (for example, double tax depreciation claims).
- 4.33 As identified in paragraph 4.18 above, Australia has the option to consider simpler implementation options for tracking DDs and dual inclusion income. Consideration can also be given to whether excess deductions could be set-off against non-dual inclusion income if such deductions cannot be offset against any income under the laws of the other jurisdiction that is not dual inclusion income.

RECOMMENDATION 7 – DUAL RESIDENT PAYER RULE

- 4.34 Recommendation 7 is set out in Chapter 7 of the Action 2 Report and is illustrated by example 7.1.
- 4.35 Recommendation 7 applies to DD outcomes that arise because a dual resident entity is able to claim a deduction for a single economic expense in more than one jurisdiction. There is no mismatch to the extent the deduction is set-off against income that is included as income in both jurisdictions (dual inclusion income).
- 4.36 The rule recommends that both jurisdictions should apply the primary rule to restrict the deduction to dual inclusion income. Any excess can be carried

forward to set-off dual inclusion income in another period. Similar issues, as raised in paragraph 4.32 and 4.33 above also apply to this recommendation.

Consultation questions

The Board invites comments from stakeholders on the following:

Q24. Are there any concerns that arise from adopting recommendation 6 or 7?

Q25. To what extent should Australia include non-cash items such as depreciation and amortisation as potential double deductions?

Q26. Can you suggest any simple implementation solutions that could be adopted in Australia to track transactions that give rise to double deductions?

RECOMMENDATION 8 – IMPORTED MISMATCH RULE

- 4.37 Recommendation 8 is set out in Chapter 8 of the Action 2 Report and is illustrated by examples 8.1 – 8.16 (refer especially to examples 8.1, 8.3 and 8.5).
- 4.38 The imported mismatch rule is designed to prevent taxpayers from entering into structured arrangements or arrangements with group members in jurisdictions that have not introduced anti-hybrid rules, to indirectly shift the tax advantage from the hybrid mismatch to a jurisdiction that has not applied the rules. This may be through the use of a non-hybrid instrument such as an ordinary loan.
- 4.39 Tracing and priority rules will need to apply to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement.¹⁵
- 4.40 Concerns have been raised in preliminary consultations that potential operation of this rule could give rise to considerable complexity and compliance. It is noted there are other provisions in the existing tax law, such as section 974-80,¹⁶ that require tracing of funding arrangements between chains of entities. The Action 2 Report considers these rules necessary to maintain the integrity of the other hybrid mismatch rules and notes that while the imported mismatch rule involves an unavoidable degree of co-ordination and complexity, they only apply to the extent a multinational group generates an intra-group hybrid deduction.
- 4.41 The recommendation is limited to transactions with entities that are resident in a jurisdiction that has not implemented anti-hybrid rules. It does not specifically deal with the insertion of an intra-group entity in a low or no tax jurisdiction.

¹⁵ Paragraph 246 of the final Action 2 Report sets out the suggested priority rules ((1) structured imported mismatches, (2) direct imported mismatches, and (3) indirect imported mismatches).

¹⁶ The Government announced in April 2015 that, as recommended by the Board of Taxation in its report following its review of the debt and equity tax rules, section 974-80 will be repealed.

Consultation questions

The Board invites comments from stakeholders on the following:

Q27. The imported mismatch rule relies on the on-lending funding arrangements to be traced through multiple jurisdictions. What, if any, challenges arise from this approach? Can you suggest an alternative method of establishing an appropriate disallowance which meets the policy objectives of the imported mismatch rule?

Q28. Are there any other concerns that arise from adopting recommendation 8?

Q29. Are Australia's existing anti-avoidance rules sufficiently robust to address direct and indirect imported mismatch arrangements?

CHAPTER 5: DEFINITIONS - RECOMMENDATION 10, 11 AND 12

- 5.1 Chapters 10, 11 and 12 of the Action 2 Report recommend definitions for jurisdictions to adopt as part of their anti-hybrid rules. Consideration will need to be given to whether and how the definitions can be integrated into existing tax law definitions.
- 5.2 These include general and specific definitions for the purposes of applying Recommendations 1 – 8 of the Action 2 Report.

DEFINITION OF ‘STRUCTURED ARRANGEMENT’

- 5.3 Structured arrangement is defined as ‘any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch’.¹⁷
- 5.4 The test for what is a structured arrangement is objective and applies regardless of the parties’ intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch.

DEFINITION OF ‘RELATED PARTY’ AND ‘CONTROL GROUP’

- 5.5 Two persons are related if they are in the same control group or if one person has a 25 per cent investment in the other person or a third person holds a 25 per cent or greater investment in both.¹⁸ The test measures both direct and indirect investment, which includes voting rights and the value of any equity interests. If two or more people act together in respect of the ownership or control of an investment, they are required to aggregate their ownership interests for purposes of the related party test.¹⁹
- 5.6 Parties will broadly be treated as members of the same control group²⁰ if they form part of the same consolidated group for accounting purposes, if they are treated as associated enterprises under Article 9 of the OECD Model Tax Convention 2014, if one person has a 50 per cent investment in the other or someone has a 50 per cent investment in both or if there is effective control (whether directly or indirectly).

¹⁷ Specific examples of structured arrangements are set out Recommendation 10.2 of the Action 2 Report.

¹⁸ Recommendation 11.1(a).

¹⁹ Recommendation 11.2 and 11.3.

²⁰ Recommendation 11.1(b).

- 5.7 There is likely to be limited scope for Australia to adopt a different definition of related party or control group, however, the Board would like to understand the practical issues that may arise from the recommended definitions.

OTHER DEFINITIONS

- 5.8 Recommendation 12 of the Action 2 Report provides a suite of other definitions for jurisdictions to adopt as part of their anti-hybrid rules.

Consultation questions

The Board invites comments from stakeholders on the following:

- Q30. Whether the OECD's suggested definition of a structured arrangement is appropriate? Could it be modified to apply more appropriately and, if so, how?
- Q31. Can you provide examples of transactions that are, or may be, structured arrangements?
- Q32. Whether there are any particular types of arrangements that may, inadvertently, be caught by the definition?
- Q33. Whether there are any issues that arise if Australia adopted the OECD recommendation of a 25 per cent interest for the definition of related party? Would any issues arise if a different definition of related party were adopted?
- Q34. Whether there are any specific concerns with any recommended definitions in chapters 10, 11 and 12? For example, the definition of 'deduction' in Chapter 12 is broad and may include foreign tax credits or offsets. Does this give rise to any specific concerns?

CHAPTER 6: EXCEPTIONS AND OTHER LEGISLATIVE DESIGN AND COMPLIANCE ISSUES

EXCEPTIONS

- 6.1 The Board considers that given the complex nature of the anti-hybrid rules, it would be appropriate to examine whether these rules should apply to all arrangements in Australia that fall within its scope.

Regulatory capital

- 6.2 The Action 2 Report indicates that countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital.
- 6.3 The UK consultation paper, released in 2014, contains the UK's preliminary response to the OECD draft paper ([link](#)). The consultation paper notes that the general mismatch rules are targeted towards intra-group transactions and should not generally impact UK banks issuing regulatory hybrid capital to third party investors. However, concerns were noted that hybrid regulatory capital may be legitimately issued intra-group as a number of regulators, including the UK and US, increasingly require banks to issue regulatory capital externally at the top holding company level and then downstream this to operating subsidiaries. The UK proposed special provisions to accommodate down-streaming of externally issued regulatory capital.
- 6.4 In preliminary consultations, concerns were raised by the banking sector that the definition of structured arrangement could be interpreted to include hybrid regulatory capital issued externally to third parties. In addition, recommendation 2.1 can potentially apply to deny franking credits for hybrid financial instruments even if it is not made to a related person and is not a structured arrangement.
- 6.5 Consideration will need to be given as to whether special rules are required to address potential inappropriate outcomes which may arise for:
- (a) Australian banks raising regulatory capital on behalf of, or via, offshore branches or subsidiaries;
 - (b) for Australian operations of foreign banks. For example, if the UK introduces specific rules to exempt intra-group downstreaming of regulatory capital, absent a special rule Australia's anti-hybrid rules could negate the UK's allowance of an exemption at the parent level by disallowing the deduction at the subsidiary level.

Consultation questions

The Board invites stakeholder comment on the following:

Q35. Whether hybrid arrangements that form part of a financial institution's regulatory capital should be carved out of Australia's anti-hybrid rules? Could (and should) any carve out be limited to regulatory capital issued to third parties?

Q36. Are there any other regulatory capital concerns that require special rules? For example, does Australia need specific rules to deal with regulatory capital issued to third parties but is then passed on to group members through back to back arrangements?

OTHER EXCEPTIONS

6.6 The Action 2 Report considered that securitisation vehicles and certain investment vehicles²¹ should be carved out from the hybrid financial instrument rule to protect the tax neutrality of these vehicles.²² The UK included in its consultation paper a preliminary list of carve outs which included unit trusts, open-ended investment companies, investment trusts and bodies with charitable exemption.

Consultation questions

The Board seeks stakeholder comment on the following:

Q37. With the exception of those suggested in the Action 2 Report, whether there are any other types of entities that should be excluded from the operation of the anti-hybrid rules? If so, please explain why an exception is appropriate (noting the policy that any exceptions should be to protect tax neutrality).

Q38. Whether there are particular types of transactions that should be excluded from the operation of the anti-hybrid rules? If so, please explain why an exception is appropriate.

21 The OECD paper refers to investment vehicles in a jurisdiction that grants the vehicle the right to deduct dividend payments.

22 Recommendation 1.5.

LEGISLATIVE DESIGN

- 6.7 The Board wishes to minimise the legislative complexity for taxpayers but still ensure that the anti-hybrid rules are certain in their scope, application and effect to minimise compliance costs.
- 6.8 In designing the legislation, it would be desirable for the anti-hybrid rules to be flexible and adaptive to cater for emerging arrangements, commercial and otherwise, without the need for constant amendments to keep up to date or to ensure that it applies to all intended situations.
- 6.9 One approach for addressing legislative complexity is to adopt a principles based drafting approach, which may be supplemented by detailed explanatory memorandum commentary and ATO guidance materials. However, such an approach may also result in greater uncertainty when applying the legislation. Another approach could be a prescriptive set of rules.

Consultation questions

Q39. The Board invites comments from stakeholders on whether a principles based drafting approach, or alternatively, a black letter approach should be adopted in drafting the anti-hybrid rules.

COMPLIANCE AND ADMINISTRATION ISSUES

- 6.10 As taxpayers will be expected to self-assess the application of the anti-hybrid rules, a number of compliance and administrative issues could arise in identifying and quantifying hybrid mismatches.
- 6.11 Taxpayers applying the rules will need to understand how a financial instrument or entity is treated in another jurisdiction. In addition, taxpayers will also need to know whether or not the hybrid rules have been implemented in a counterparty jurisdiction (or a chain of jurisdictions in the case of an imported mismatch).

Consultation questions

The Board invites comments from stakeholder on the following:

Q40. The practical challenges that may arise for taxpayers in identifying the tax treatment for a counterparty or in a counterparty jurisdiction.

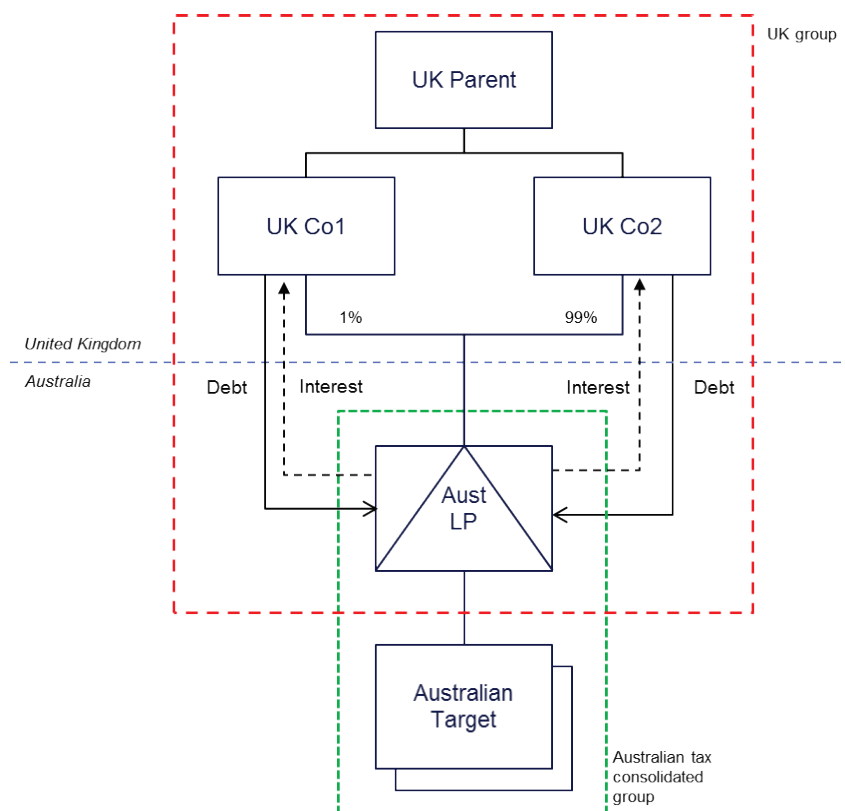
Q41. The level of evidence required to support a self-assessment under the anti-hybrid rules. Should actual knowledge of the tax affairs of the other taxpayer or just reasonable knowledge of the tax rules of another jurisdiction be required?

APPENDIX A: TERMS OF REFERENCE

1. The Board of Taxation is asked to undertake consultation on the implementation of new tax laws to neutralise hybrid mismatch arrangements (anti-hybrid rules), pursuant to the recommendations of the G20 and OECD under Action Item 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan.
2. Hybrid mismatch arrangements can be used to achieve double non-taxation, including long-term tax deferral. They reduce the collective tax base of countries around the world even if it may sometimes be difficult to determine which individual country has lost tax revenue. Under Action 2 of the BEPS Action Plan, the OECD has developed recommendations regarding the design of anti-hybrid rules.
3. Guidance on the practical operation of the rules and refinements on some outstanding issues will be released in a report in October 2015. The commentary will set out the principles underpinning the recommendations, agreed definitions and will include detailed examples of the practical application of the anti-hybrid rules.
4. The Board is asked to examine how best to implement anti-hybrid rules in the Australian legal context. In particular, the Board should identify an implementation strategy that has regard to:
 - Delivering on the objectives of eliminating double non-taxation, including long term tax deferral;
 - Economic costs for Australia;
 - Compliance costs for taxpayers; and
 - Interactions between Australia's domestic legislation (e.g. the debt-equity rules and regulated capital requirements for banks), international obligations (including tax treaties) and the new anti-hybrid rules.
5. The Board should conduct targeted consultation with relevant parties. We ask that the Board utilise its extensive links with tax professionals and key business groups. The Board should also work closely with Treasury and Australian Taxation Office in preparing its advice.
6. Further, the advice should utilise and build upon the conclusions of the Board's recent review of Australia's debt/equity rules and its consultation with businesses about their perspective on the G20/OECD BEPS Action Plan.
7. The Board is requested to report to Government by March 2016 to allow this issue to be considered as part of the 2016 Budget.

APPENDIX B – DIAGRAMMATIC EXAMPLES

EXAMPLE 1: AUSTRALIAN LIMITED PARTNERSHIP (ANTI-HYBRID RECOMMENDATION 3 – DISREGARDED PAYMENTS RULE)



This example is expected to give rise to the following outcomes:

Australia

- Australia would treat the Aust LP as a company under Division 5A of the 1936 Act.
- The Aust LP is the head company of the Australian income tax consolidated group and incurs interest to acquire the Australian Target.
- 10 per cent interest withholding tax would apply on interest paid to UK Co1 and UK Co2.

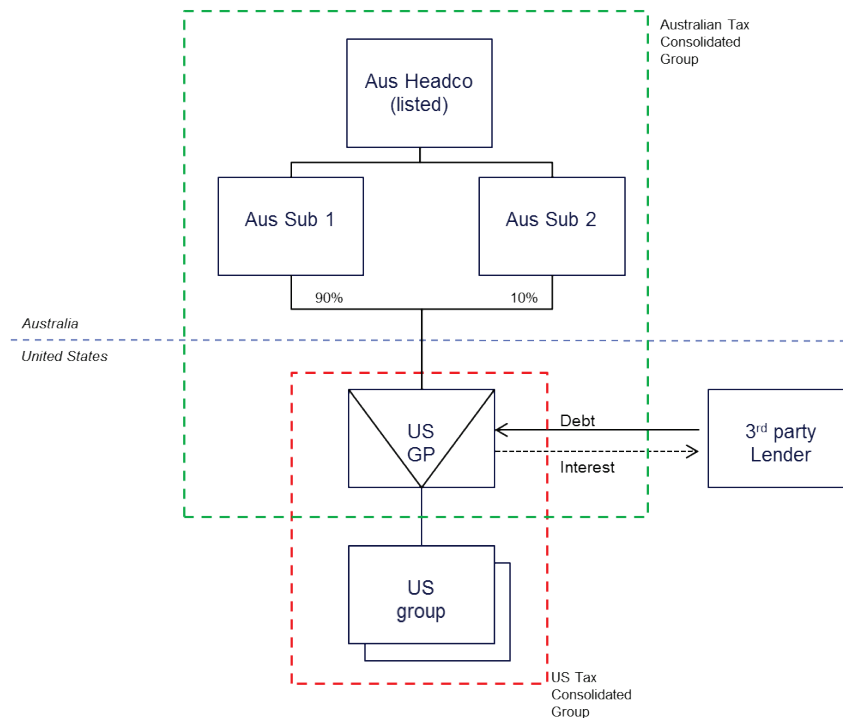
United Kingdom

- The Aust LP is treated as a partnership. The interest income and interest expense is disregarded as the Aust LP is transparent for tax purposes.

BEPS anti-hybrid rule

- Disregarded hybrid payments rule applies. Under recommendation 3, the Aust LP would be denied the interest deduction (the primary rule). If Australia did not implement the anti-hybrid rules and the UK did, under the secondary rule, the UK Co1 and UK Co2 would include the disregarded payment in ordinary income. The Australian Target income is not dual inclusion income.

EXAMPLE 2: US GENERAL PARTNERSHIP (ANTI-HYBRID RECOMMENDATION 6 – DEDUCTIBLE HYBRID PAYMENTS RULE)



This example is expected to give rise to the following outcomes:

Australia

- Australia treats the US GP as a partnership and the interest expense is treated as incurred by Aus Headco under Australia's income tax consolidation rules.
- Dividends paid by the US group are exempt under subdivision 768-A of the 1997 Act.
- Distributions from the US GP to Aus Sub 1 and Aus Sub 2 are disregarded because the distributions are between members of the same Australian income tax consolidated group.
- 0 per cent interest withholding tax would apply to the extent that the third party lender is a 'US financial institution lender' or by virtue of section 128F of the 1936 Act.

United States

- From a US perspective, the US GP makes a 'check-the-box' election under US law to treat the entity as a company ('checked closed').
- The interest expense is deductible against US group income. 0 per cent dividend withholding tax would apply on dividends paid from US GP to Aus Sub 1 and Aus Sub 2 by virtue of the Double Tax Agreement listed company exemption.

BEPS anti-hybrid rule

- Recommendation 6 (deductible hybrid payments rule) would apply to deny Aus Headco an interest deduction. If Australia did not implement the rules and the US did, the secondary rule would apply to deny the interest deduction in the US. Any US Group income is not dual inclusion income.