

EXPOSURE DRAFT

TREASURY LAWS AMENDMENT (OECD HYBRID MISMATCH RULES)
BILL 2017

EXPLANATORY MEMORANDUM

Table of contents

Glossary	1
Chapter 1 OECD hybrid mismatch rules	3
Chapter 2 Other effects of foreign income tax deductions	57

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
G20	Group of 20 — comprising Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
OECD	Organisation for Economic Co-operation and Development
OECD Action 2 Report	OECD report on <i>Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, 2015 Final Report</i>

Chapter 1

OECD hybrid mismatch rules

Outline of chapter

1.1 Schedule 1 to this Exposure Draft Bill amends the ITAA 1997 to prevent entities that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries.

1.2 All references in this chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.3 In 2015, as part of the OECD/G20 Base Erosion and Profits Shifting Project, the OECD released the OECD Action 2 Report which makes recommendations to neutralise the effects of hybrid mismatch arrangements.

1.4 In the 2015-16 Budget, the Government asked the Board of Taxation to consult on the implementation of the OECD hybrid mismatch rules. The Board completed its Report on the *Implementation of the OECD Hybrid Mismatch Rules* in March 2015.

1.5 In the 2016-17 Budget, the Government announced that it would implement the recommendations made in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation.

1.6 In the 2017-18 Budget, the Government further announced that it would eliminate hybrid tax mismatches that occur in cross border transactions relating to Additional Tier 1 regulatory capital, including transitional rules for Additional Tier 1 capital instruments issued before 9 May 2017 (see Chapter 2).

1.7 In broad terms, hybrid mismatch arrangements arise where entities exploit differences in the taxation treatment of an entity or instrument under the laws of at least two tax jurisdictions to defer or reduce income tax. This can result in double non-taxation, including long term tax deferral.

1.8 The most common types of hybrid mismatch arrangements are ‘double deduction’ and ‘deduction/non-inclusion’ arrangements.

- A deduction/non-inclusion mismatch occurs when a deduction is provided for a payment in one country, but the corresponding income is not included as assessable income in the recipient country.
- A double deduction mismatch occurs when a business receives a deduction in two countries for the same payment.

1.9 A simple example of a deduction/non-inclusion hybrid mismatch is a financial instrument that is treated as:

- debt in one country, usually providing the issuer with a deduction for any interest paid; and
- equity in another country, usually providing the holder with an exemption for any dividends received from the other country.

1.10 Hybrid mismatches are a significant problem for the tax system when an arrangement involves related parties or is deliberately structured to result in a mismatch because it provides an opportunity to eliminate taxes that would otherwise be payable on business income unrelated to the arrangement.

1.11 Hybrid mismatch arrangements can reduce the collective tax base of countries around the world even though it can be difficult to determine which country has lost tax revenue.

1.12 The principal objective of the hybrid mismatch rules is to neutralise the effects of hybrid mismatches so that unfair tax advantages do not accrue for multinational groups as compared with domestic groups.

1.13 In this regard, the OECD Action 2 Report concludes that hybrid mismatch arrangements are widespread and result in a substantial erosion of the tax bases of countries concerned, with an overall negative impact on competition, efficiency, transparency and fairness. The OECD and the G20 considered the approach recommended in the OECD Action 2 Report to be the only comprehensive and coherent way to tackle global tax avoidance and to discourage uncompetitive tax arbitrage.

1.14 The OECD Action 2 Report sets out comprehensive rules for dealing with hybrid mismatch arrangements. The amendments in Schedule 1 to this Exposure Draft Bill follow closely the OECD’s recommendations. Some departures occur principally to take into account

recommendations of the Board of Taxation and to allow for unique features of the Australian tax system that were not specifically contemplated by the OECD recommendations.

1.15 The hybrid mismatch rules neutralise the effects of hybrid mismatches by modifying the outcomes that arise under the Australian income tax law where the effect of the mismatch is not neutralised under the taxation law in a foreign jurisdiction.

1.16 The United Kingdom enacted laws to address hybrid mismatch arrangements with effect from 1 January 2017. It is expected that New Zealand will adopt similar laws in 2018. European Union member states have also committed to apply hybrid mismatch rules by 1 January 2020.

Summary of new law

1.17 Schedule 1 to this Exposure Draft Bill amends the ITAA 1997 by inserting the OECD hybrid mismatch rules into Division 832.

1.18 These rules will prevent entities (including multinational corporations) that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries.

1.19 The rules implement the recommendations in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation.

1.20 Broadly, a hybrid mismatch will arise if:

- an entity enters into a scheme that gives rise to a payment; and
- the payment gives rise to:
 - a deduction/non-inclusion mismatch; or
 - a deduction/deduction mismatch.

1.21 A mismatch will be covered by the hybrid mismatch rules if it is:

- a hybrid financial instrument mismatch;

- a hybrid payer mismatch;
- a reverse hybrid mismatch;
- a deducting hybrid mismatch; or
- an imported hybrid mismatch.

1.22 If a mismatch arises, it is neutralised by:

- disallowing a deduction; or
- including an amount in assessable income.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>The hybrid mismatch rules will prevent entities that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries.</p> <p>Broadly, a hybrid mismatch will arise if:</p> <ul style="list-style-type: none"> • an entity enters into a scheme that gives rise to a payment; and • the payment gives rise to: <ul style="list-style-type: none"> – a deduction/non-inclusion mismatch; or – a deduction/deduction mismatch. <p>A mismatch will be covered by the hybrid mismatch rules if it is:</p> <ul style="list-style-type: none"> • a hybrid financial instrument mismatch; • a hybrid payer mismatch; • a reverse hybrid mismatch; • a deducting hybrid mismatch; or • an imported hybrid mismatch. <p>If a mismatch arises, it is neutralised</p>	<p>Entities can exploit differences in the taxation treatment of an entity or instrument under the laws of at least two tax jurisdictions by entering into hybrid mismatch arrangements designed to defer or reduce income tax. This can result in double non-taxation, including long term tax deferral.</p>

<p>by:</p> <ul style="list-style-type: none"> • disallowing a deduction; or • including an amount in assessable income. 	
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Detailed explanation of new law

1.23 Schedule 1 to this Exposure Draft Bill amends the ITAA 1997 by inserting the hybrid mismatch rules into Division 832.

1.24 A hybrid mismatch arises if double non-taxation results from the exploitation of differences in the tax treatment of an entity or financial instrument under the laws of two or more countries. There is double non-taxation if:

- a deductible payment is not included in the tax base; or
- a payment gives rise to two deductions but is included in the tax base only once.

[Schedule 1, item 1, section 832-1]

1.25 Disallowing a deduction, or including an amount in assessable income neutralises this tax advantage. *[Schedule 1, item 1, section 832-1]*

1.26 Broadly, a hybrid mismatch will arise if:

- an entity enters into a scheme that gives rise to a payment; and
- the payment gives rise to:
 - a deduction/non-inclusion mismatch; or
 - a deduction/deduction mismatch.

1.27 A mismatch will be covered by the hybrid mismatch rules if it is:

- a hybrid financial instrument mismatch;
- a hybrid payer mismatch;
- a reverse hybrid mismatch;
- a deducting hybrid mismatch; or

- an imported hybrid mismatch.

1.28 If a mismatch arises, it is neutralised by:

- disallowing a deduction; or
- including an amount in assessable income.

1.29 A number of core concepts apply throughout the hybrid mismatch rules (see Subdivision 832-P, Subdivision 832-Q and subsection 995-1(1)). These core concepts, which are explained later in this Chapter, are:

- Australian income reduction amount;
- Division 832 control group;
- dual inclusion income;
- foreign hybrid mismatch rules;
- foreign income tax deduction;
- foreign tax period;
- liable entity;
- party to a structured arrangement;
- structured arrangement;
- subject to Australian income tax;
- subject to foreign income tax; and
- tax base purpose.

When do the hybrid mismatch rules apply?

An entity must make a payment to a recipient

1.30 The hybrid mismatch rules in Division 832 apply if an entity (the payer) makes a deductible payment to another entity (the recipient).

1.31 In this regard, if a payment is made to two or more recipients, then the hybrid mismatch rules apply as if each part of the payment made

to each such recipient were a separate payment. [*Schedule 1, item 1, subsection 832-30(2)*]

1.32 The hybrid mismatch rules apply in relation to a payment whether or not the scheme under which the payment is made has been or is entered into or carried out:

- in Australia;
- outside Australia; or
- partly in Australia and partly outside Australia.

[*Schedule 1, item 1, section 832-45*]

1.33 A *scheme* is defined in subsection 995-1(1) to mean:

- any arrangement; or
- any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

1.34 The identification of the scheme is determined having regard to the facts and circumstances of a particular case. In this regard, a particular scheme can be very broad to cover multiple entities and multiple periods of time. Alternatively, a particular scheme can be relatively narrow to cover a single entity and a single period of time.

The recipient has an entitlement to a payment, or is entitled to receive a non-cash benefit

1.35 The hybrid mismatch rules will also apply to an entity (the payer) if:

- another entity (the recipient) is entitled to receive the payment from the payer, even if the payment is not required to be made until a later time — that is, for example, the payment accrues to the recipient; or
- the recipient received a non-cash benefit from the payer — that is, for example, the payer provided services to the recipient.

[*Schedule 1, item 1, section 832-15, section 832-20 and subsection 832-30(1)*]

The payer is entitled to an accrual deduction

1.36 The hybrid mismatch rules apply to a loss in the same way as they apply to a payment if

- the loss gives rise to:
 - an *Australian income reduction amount* (see the Core concepts) for an entity (the payer) for an income year; or
 - a *foreign income deduction* (see the Core concepts) for an entity (also the payer) for a *foreign tax period* (see the Core concepts) that starts in the income year; and
- the loss consists of all or part of a payment that will be made to another entity (the recipient) in a later income year.

[Schedule 1, item 1, section 832-25 and subsection 832-30(1)]

1.37 This will ensure that the hybrid mismatch rules will apply to an amount that is deductible as it accrues (as distinct from when it is paid). In this instance:

- the entity with the loss will be the payer; and
- the entity that will be entitled to receive all or part of the payment in a later year will be the recipient.

Certain tax provisions disregarded in identifying entities, income or profits, and payments

1.38 For the purpose of determining whether an entity makes a payment to another entity, or for determining the amount of income or profits of an entity, under hybrid mismatch rules the single entity rule (subsection 701-1(1)) under Australia's tax consolidation regime is disregarded. As a result:

- income or profits made by entities within a consolidated group are recognised; and
- payments by a member of a consolidated group (including intra-group payments) are recognised.

[Schedule 1, item 1, section 832-35]

1.39 As a consequence, a member of an Australian tax consolidated group may be a hybrid payer (under section 832-585) or a deducting

hybrid (under section 832-725). However, because of subparagraph 832-655(a)(ii), it cannot be a reverse hybrid.

1.40 Any law of a foreign country that, for the purposes of a foreign tax, treats those income or profits as income or profits of another entity is also disregarded. Consequently, any foreign law that has a similar effect to the single entity rule under Australia's tax consolidation regime is disregarded. *[Schedule 1, item 1, section 832-35]*

Example 1.1: Disregarding the single entity rule when identifying entities

Aus Sub is a subsidiary member of an Australian tax consolidated group. Aus Sub receives payments from customers in respect of services provided. The single entity rule would ordinarily apply so that the payments are taken to be received by the head company of the Australian tax consolidated group.

However, the single entity rule is disregarded for the purposes of testing whether Aus Sub is a hybrid payer or a deducting hybrid.

As a result, for the purpose of testing whether Aus Sub is a hybrid payer or a deducting hybrid, the payments received from customers in respect of services provided are treated as income or profits of Aus Sub.

Example 1.2: Disregarding the single entity rule when identifying payments

Aus Sub (from Example 1.1) borrows money from another member of the Australian tax consolidated group and pays interest on the borrowing. The single entity rule would ordinarily apply so that the payment is not recognised as a deduction or as assessable income for Australian income tax purposes.

However, the single entity rule is disregarded for the purposes of determining whether there is a hybrid mismatch.

As a result, for the purpose of determining whether there is a hybrid mismatch, the interest paid by Aus Sub is recognised as a payment.

1.41 However, for all other purposes in the hybrid mismatch rules, the single entity rule is not disregarded. *[Schedule 1, item 1, section 832-40]*

1.42 This means that, for example, if a hybrid mismatch arrangement involves a member of a consolidated group, a mismatch will be neutralised by:

- disallowing a deduction for the head company of the group;
- or

- including an amount in head company's assessable income.

Types of mismatches

1.43 A mismatch will be covered by the hybrid mismatch rules if it is:

- a hybrid financial instrument mismatch (Subdivision 832-I);
- a hybrid payer mismatch (Subdivision 832-J);
- a reverse hybrid mismatch (Subdivision 832-K);
- a deducting hybrid mismatch (Subdivision 832-L); or
- an imported hybrid mismatch (Subdivision 832-M).

1.44 These mismatch rules are applied in order. Therefore, if a payment gives rise to a hybrid mismatch under a particular Subdivision, it will not give rise to a mismatch under a later Subdivision. [*Schedule 1, item 1, section 832-50*]

1.45 If a payment gives rise to an imported hybrid mismatch, the ordering rule does not apply. In this regard, a payment that gives rise to an imported hybrid mismatch is an importing payment (rather than a hybrid payment).

1.46 There are two types of mismatches:

- a deduction/non-inclusion mismatch; and
- a deduction/deduction mismatch.

1.47 The circumstances in which these mismatches arise are explained in detail later in this Chapter.

1.48 In this regard, in working out whether a payment gives rise to a deduction/non-inclusion mismatch or a deduction/deduction mismatch, the effects of the Subdivisions 832-B and 832-C (which have the effect of neutralising a mismatch) should be disregarded. [*Schedule 1, item 1, section 832-915*]

What is a deduction/non-inclusion mismatch?

1.49 A payment will give rise to ***deduction/non-inclusion mismatch*** if:

- the payment, or part of the payment, gives rise to:
 - an *Australian income reduction amount* (see the Core concepts) in an income year; or
 - a *foreign income tax deduction* (see the Core concepts) in a foreign country in a *foreign tax period* (see the Core concepts); and
- the amount of the Australian income reduction amount or foreign income tax deduction exceeds the sum of the amounts of the payment that are:
 - *subject to foreign income tax* (see the Core concepts) in a foreign country in a relevant foreign tax period; or
 - *subject to Australian income tax* (see the Core concepts) for a relevant income year.

[Schedule 1, items 1 and 2, subsection 832-920(1) and the definition of 'deduction/non-inclusion mismatch' in subsection 995-1(1)]

1.50 For these purposes, a foreign tax period is a relevant foreign tax period if it ends no later than 12 months after the end of the income year in which the Australian income reduction amount arose. *[Schedule 1, item 1, paragraph 832-920(2)(a)]*

1.51 Similarly, an income year is a relevant income year, or a foreign tax period is a relevant foreign tax period, if it ends no later than 12 months after the end of the foreign tax period in which the foreign income tax deduction arose in the foreign country. *[Schedule 1, item 1, paragraph 832-920(2)(b)]*

1.52 The amount of the deduction/non-inclusion mismatch is the amount of the excess. *[Schedule 1, item 1, subsection 832-920(3)]*

What is a deduction/deduction mismatch?

1.53 A payment will give rise to ***deduction/deduction mismatch*** if the payment, or part or share of the payment:

- gives rise to a *foreign income tax deduction* (see the Core concepts) in a foreign country; and
- also gives rise to:
 - an *Australian income tax reduction amount* (see the Core concepts) in an income year; or

- a *foreign income tax deduction* (see the Core concepts) in a foreign country (other than the country mentioned in paragraph 832-925(1)(a)).

[Schedule 1, items 1 and 2, subsection 832-925(1) and the definition of 'deduction/deduction mismatch' in subsection 995-1(1)]

1.54 A deduction/deduction mismatch does not arise simply because:

- a part or a share of a payment gives rise to a deduction; and
- another part or share of that payment also gives rise to a deduction.

1.55 For example, partners in a general law partnership do not have a deduction/deduction mismatch merely by virtue of being in a partnership. However, partners in a partnership may have a deduction/deduction mismatch if other hybridity factors are present.

1.56 The amount of the deduction/deduction mismatch is the lesser of:

- the amount of the foreign income tax deduction mentioned in paragraph 832-925(1)(a); and
- the sum of the amounts of the Australian income tax reduction amount, or the foreign income tax deduction, mentioned in paragraph 832-925(1)(b)(i) or (ii).

[Schedule 1, item 1, subsection 832-925(2)]

Neutralising hybrid mismatches

1.57 If a hybrid mismatch arises, the tax advantage obtained from the mismatch is neutralised by, broadly, disallowing a deduction or including an amount in assessable income. The neutralising rule that applies depends on whether the entity affected by the neutralising rule is:

- a deducting entity; or
- a non-including entity.

1.58 Where the mismatch is a hybrid payer mismatch or deducting hybrid mismatch, the amount of a hybrid mismatch that is neutralised is reduced by *dual inclusion income* (see the Core concepts).

1.59 An amount of dual inclusion income is available to be applied by a provision of Division 832 to reduce an amount if:

- for an amount that is an Australian income reduction amount for an income year — the dual inclusion income is subject to Australian income tax in the income year; or
- for an amount that is a foreign income tax deduction, or a net loss mentioned in subsection 832-715(5), in a foreign country, for a foreign tax period — the dual inclusion income is subject to foreign income tax in the foreign tax period.

[Schedule 1, item 1, subsection 832-1020(3)]

1.60 An amount of dual inclusion income is available to be applied by section 832-235 to create an adjustment for an entity in an income year if the dual inclusion income is subject to Australian income tax in the income year. That is, an amount of dual inclusion income which arises in a later income year can be used to generate a deduction from the amount of the hybrid mismatch disallowed in the earlier income year. *[Schedule 1, item 1, section 832-235 and subsection 832-1020(4)]*

1.61 An amount of dual inclusion income is not available to be applied by a provision of Division 832 if the amount has already been applied by a previous application of a provision of the Division.

[Schedule 1, item 1, subsection 832-1020(5)]

The primary response — Neutralising hybrid mismatches for a deducting entity

1.62 The primary response to neutralise a hybrid mismatch is to deny a deduction for a deducting entity.

1.63 This neutralising rule applies to an entity if, apart from section 832-105, the entity would have an *Australian income reduction amount* (see the Core concepts) in an income year in respect of a payment that gives rise to:

- a hybrid financial instrument mismatch;
- a hybrid payer mismatch;
- a reverse hybrid mismatch;
- a deducting hybrid mismatch; or

- an imported hybrid mismatch.

[Schedule 1, item 1, subsection 832-105(1)]

1.64 If the primary response applies, then the hybrid mismatch is neutralised by:

- if the Australian income reduction amount is an amount the entity could otherwise deduct in an income year — disallowing all or part of the deduction; or
- if the Australian income reduction amount is an amount that is an element in the calculation of a net amount that is included in the entity assessable income or allowed as a deduction — disregarding all or part of the Australian income reduction amount in performing the relevant calculation.

[Schedule 1, item 1, subsection 832-105(2)]

1.65 However, the neutralising rule in subsection 832-105(2) does not apply to an entity in respect of a payment (other than a payment that gives rise to an imported hybrid mismatch) if:

- the scheme under which the payment is made is a *structured arrangement* (see the Core concepts);
- if the scheme under were not a structured arrangement, subsection 832-110(2) would not apply; and
- the entity is not a *party to the structured arrangement* (see the Core concepts).

[Schedule 1, item 1, subsection 832-105(4)]

1.66 The amount that is disallowed or disregarded (the neutralising amount) in relation to an Australian income reduction amount for an income year (the deducting year) in respect of a payment is so much of amount as does not exceed the amount of the hybrid mismatch. *[Schedule 1, item 1, subsection 832-105(3) and section 832-110]*

Adjustment if hybrid financial instrument payment is income in a later year

1.67 If an amount that gave rise to a hybrid mismatch is a hybrid financial instrument payment that is appropriately recognised in a later income year, an adjustment is made in that later income year to allow the deduction.

1.68 The adjustment applies for an income year (the adjustment year) if:

- an amount was disallowed or disregarded for the entity in an earlier income year under subsection 832-105(2) in respect of a payment that gave rise to a hybrid financial instrument mismatch; and
- an amount (the taxed amount) of the payment is:
 - subject to foreign income tax in a foreign country in a relevant foreign tax period; or
 - subject to Australian income tax in a relevant income year.

[Schedule 1, item 1, subsections 832-230(1)]

1.69 However, no adjustment is available if the hybrid mismatch arises because of section 832-515. *[Schedule 1, item 1, subsection 832-230(5)]*

1.70 For these purposes, a foreign tax period or income year is a relevant foreign tax period or relevant income year if it is not covered by subsection 832-920(2) in relation to the hybrid mismatch and:

- for an income year — it is the adjustment year; or
- for a foreign tax period — it ends within 12 months after the end of the adjustment year.

[Schedule 1, item 1, subsection 832-230(2)]

1.71 In these circumstances, the entity can deduct the taxed amount in the adjustment year. *[Schedule 1, item 1, subsection 832-230(3)]*

1.72 However, the total amounts deducted must not exceed the amount disallowed, or disregarded, in respect of the payment. *[Schedule 1, item 1, subsection 832-230(4)]*

Adjustment if hybrid entity derives dual inclusion income in a later year

1.73 If a hybrid entity derives *dual inclusion income* (see the Core concepts) in a later year, an adjustment is made in that later income year to offset the neutralising amount.

1.74 The adjustment applies for an entity for an income year (the adjustment year) if:

- an amount was disallowed or disregarded for the entity in an earlier income year under subsection 832-105(2) in respect of a payment that gave rise to a hybrid payer mismatch or a deducting hybrid mismatch; and
- an amount of dual inclusion income of the hybrid payer or the deducting hybrid is available to be applied for these purposes in the income year.

[Schedule 1, item 1, subsection 832-235(1)]

1.75 In these circumstances, so much of the dual inclusion income that can be applied for these purposes as does not exceed the amount disallowed or disregarded can be deducted by the entity in the adjustment year. *[Schedule 1, item 1, subsection 832-235(2)]*

1.76 However, for the purposes of a later application of section 832-235, the amount that was disallowed or disregarded under subsection 832-105(2) is taken to be reduced by the amount of any prior adjustments. *[Schedule 1, item 1, subsection 832-235(3)]*

The secondary response — Neutralising hybrid mismatches for a non-including entity

1.77 The secondary or defensive response to neutralise a hybrid mismatch is to include an amount in assessable income.

1.78 This neutralising rule applies to an entity if the entity is the recipient of a payment that gives rise to:

- a hybrid financial instrument mismatch; or
- a hybrid payer mismatch.

[Schedule 1, item 1, subsection 832-165(1)]

1.79 If the secondary response applies, then the hybrid mismatch is neutralised by including an amount in the entity's assessable income. The amount included is taken to have been derived from the same source as the payment that gave rise to the mismatch. *[Schedule 1, item 1, subsection 832-165(2)]*

1.80 The income year (the inclusion year) in which the entity is taken to have derived the amount is:

- if the *foreign tax period* (see the Core concepts) in which the *foreign income tax deduction* (see the Core concepts) that gave rise to the mismatch (as mentioned in

paragraph 832-920(1)(a) is allowed falls wholly within an income year of the entity — that income year; or

- if the foreign tax period in which the foreign income tax deduction that gave rise to the mismatch (as mentioned in paragraph 832-920(1)(a)) is allowed straddles two income years of the entity — the earlier of those income years.

[Schedule 1, item 1, subsection 832-165(3)]

1.81 However, the neutralising rule in section 832-165 does not apply to an entity in respect of a payment if:

- the scheme under which the payment is made is a *structured arrangement* (see the Core concepts);
- if the scheme under were not a structured arrangement, section 832-165 would not apply; and
- the entity is not a *party to the structured arrangement* (see the Core concepts).

[Schedule 1, item 1, subsection 832-165(4)]

1.82 If the hybrid mismatch relates to a financial arrangement, where a gain or loss on the financial arrangement is recognised under the Taxation of Financial Arrangement rules (Division 230), section 230-20 does not apply to prevent an amount from being included in an entity's assessable income under section 832-165. *[Schedule 1, item 1, subsection 832-165(5)]*

1.83 The amount that is included in assessable income (the neutralising amount) is an amount equal to the amount of the hybrid mismatch. *[Schedule 1, item 1, subsections 832-170(1) and (2)]*

1.84 However, in working out the amount of the hybrid mismatch, an amount of *dual inclusion income* (see Core concepts) is not be applied under section 832-575 unless it is subject to Australian income tax in the inclusion year. *[Schedule 1, item 1, subsection 832-170(3)]*

1.85 If a neutralising amount is included in an entity's assessable income under section 832-165 in an income year, that amount is not included in the entity's assessable income, or taken into account in the calculation of a net amount that is included in the entity's assessable income, in a later income year. *[Schedule 1, item 1, section 832-175]*

Hybrid financial instrument mismatch (Subdivision 832-I)

What is a hybrid financial instrument mismatch?

1.86 A payment gives rise to a **hybrid financial instrument mismatch** if the payment gives rise to a hybrid mismatch under section 832-495 or 832-510 and either:

- the entity that made the payment and an entity that is a *liable entity* (see the Core concepts) in respect of the income or profits of the recipient of the payment are related; or
- the scheme under which the payment is made is a *structured arrangement* (see the Core concepts).

[Schedule 1, items 1 and 2, subsections 832-490(1), (2) and (5), definition of 'hybrid financial instrument mismatch' in subsection 995-1(1)]

1.87 For the purposes of determining whether there is a hybrid financial instruments mismatch, two entities are related if:

- the entities are in the same Division 832 control group;
- one of the entities holds a *total participation interest* (as defined in section 960-180) of 25 per cent or more in the other entity; or
- a third entity holds a total participation interest of 25 per cent or more in each of the entities.

[Schedule 1, item 1, subsection 832-490(3)]

1.88 For these purposes, the *direct participation interest* (as defined in section 960-180) of an entity (the holding entity) in another entity (the test entity) is taken to be the sum of the direct participation interests held by the holding entity and its associates (as defined in section 318 of the ITAA 1936) in the test entity. *[Schedule 1, item 1, subsection 832-490(4)]*

When does a payment give rise to a hybrid mismatch under section 832-495?

1.89 A payment gives rise to a **hybrid mismatch** under section 832-495 if:

- the payment is made under:
 - a *debt interest* (as defined in subsection 995-1(1));

- an *equity interest* (as defined in subsection 995-1(1));
- a *derivative financial arrangement* (as defined in subsection 995-1(1)); or
- an arrangement covered by subsection 832-495(2);
- the payment might be expected to give rise to a deduction/non-inclusion mismatch; and
- the mismatch that might be expected to arise, or a part of that mismatch, meets the hybrid requirement in section 832-500 or 832-505.

[Schedule 1, items 1 and 2, subsection 832-495(1) and the definition of ‘hybrid mismatch’ in subsection 995-1(1)]

1.90 An arrangement is covered by subsection 832-495(2) if:

- the arrangement is:
 - a reciprocal purchase agreement (or repurchase agreement);
 - a securities lending arrangement; or
 - a similar arrangement; and
- under the arrangement, the entity acquires a debt interest, an equity interest or a derivative financial arrangement.

[Schedule 1, item 1, subsection 832-495(2)]

1.91 The amount of the hybrid mismatch is generally the amount of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, paragraph 832-495(3)(a)]*

1.92 However, if only part of the deduction/non-inclusion mismatch meets the hybrid requirement, the amount of the hybrid mismatch is the amount of that part of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, paragraph 832-495(3)(b)]*

1.93 For the purposes of determining whether a payment might be expected to give rise to a deduction/non-inclusion mismatch, and the amount of the mismatch, regard should be had to:

- the terms of the debt interest, equity interest, derivative financial arrangement or other arrangement (as the case requires); and
- the character of the payment.

1.94 As noted in paragraphs 84 to 86 of the OECD Action 2 Report, it is not necessary that the entities know the precise treatment of the payment in the counterparty's taxable income calculation. A taxpayer will know its own tax position and should be able to determine a reasonable expectation of the likely tax outcome for the counterparty based on its knowledge of the counterparty's identity and the tax rules in the counterparty jurisdiction.

1.95 Where a payment is made through a transparent entity or has a tax base in more than one jurisdiction, it may be necessary to understand the tax laws of more than one jurisdiction to be able to determine whether an expected deduction/non-inclusion mismatch exists.

Example 1.3: Determining the expected tax outcome

Aus Co borrows money from a shareholder that is a foreign limited partnership. The partners in the foreign limited partnership are all exempt pension funds.

The foreign limited partnership is tax transparent in both its country of formation and for the investor countries.

Aus Co looks through the foreign limited partnership and expects that the partners are exempt from tax, based on an understanding of the general taxation rules for pension funds in the respective foreign jurisdictions.

Accordingly Aus Co's deductible interest payments give rise to an expected deduction/non-inclusion mismatch.

1.96 A deduction/non-inclusion mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-500 if:

- the payment that gives rise to the mismatch is made under a debt interest, an equity interest or a derivative financial arrangement; and

- the mismatch, or the part of the mismatch, is attributable to differences in the treatment of the debt interest, equity interest or derivative financial arrangement arising from the terms of the interest or arrangement.

[Schedule 1, item 1, subsection 832-500(1)]

1.97 This could arise, for example, if redeemable preference shares that are treated as a debt interest under the Australian income tax law are treated as an equity interest under the taxation laws of a foreign country.

1.98 However, in making this decision, the following factors should be disregarded:

- the taxable status of the recipient, the payer or any other entity;
- if the payment is made under a debt interest or an equity interest, the circumstances in which the interest is held; and
- if the payment is made under a derivative financial arrangement or under an arrangement covered by subsection 832-495(2), the circumstances in which the arrangement is entered into.

1.99 As noted in paragraphs 95 to 98 of the OECD Action 2 Report, these factors are to be disregarded as a hybrid mismatch that is solely attributable to the taxable status of the taxpayer or context in which the interest is held will not be a mismatch to which the rules apply.

1.100 In contrast, if the hybrid mismatch is attributable to the tax treatment of the instrument and the mismatch would have arisen in respect of payment between taxpayers who are not entitled to any special tax treatment, the hybrid financial instruments rules will continue to apply.

Example 1.4: Determining if the expected tax outcome is attributable to the terms of the instrument

Aus Co, from Example 1.3, tests whether its deductible interest payment would be subject to foreign tax for the liable entities, disregarding the exempt status of those entities.

The deduction/non-inclusion mismatch is not attributable to the terms of the debt interest because, if the partners were not exempt pension funds, the interest payment would have been subject to foreign tax.

1.101 However, the mismatch will not meet the hybrid requirement in section 832-500 if:

- the difference in treatment of the debt interest, equity interest or derivative financial arrangement primarily relates to a deferral in the recognition of income or profits under the debt interest, equity interest or derivative financial arrangement; and
- the term of the instrument or arrangement is three years or less.

[Schedule 1, item 1, paragraph 832-500(1)(c) and subsection 832-500(2)]

1.102 A deduction/non-inclusion mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-505 if:

- the payment that gives rise to the mismatch is made under an arrangement covered by subsection 832-495(2); and
- the mismatch, or the part of the mismatch, is attributable to differences in the treatment of the arrangement.

[Schedule 1, item 1, subsection 832-505(1)]

1.103 However, the mismatch will not meet the hybrid requirement in section 832-505 if:

- the difference in treatment of the arrangement primarily relates to a deferral in the recognition of income or profits under the arrangement; and
- the term of the instrument or arrangement is three years or less.

[Schedule 1, item 1, paragraph 832-505(1)(c) and subsection 832-505(2)]

1.104 The exclusions in subsections 832-500(2) and 832-505(2) reflect the recommendation made by the Board of Taxation to exclude financial instruments or arrangements with a term of three years or less from the scope of the OECD hybrid financial instruments rule.

When does a payment give rise to a hybrid mismatch under section 832-510?

1.105 A payment gives rise to a ***hybrid mismatch*** under section 832-510 if:

- the payment gives rise to a deduction/non-inclusion mismatch;

- the payment is made under an arrangement that involves the transfer of a debt interest, an equity interest or a derivative financial arrangement;
- the payment, or part of the payment, (the substitute payment) could reasonably be regarded as having been converted into a form that is in substitution for a return (however described) on the interest or arrangement; and
- the return is covered by subsection 832-510(2).

[Schedule 1, item 1, subsection 832-510(1)]

1.106 A return is covered by subsection 832-510(2) if it is a return (however described) on a debt interest, an equity interest or a derivative financial arrangement that is transferred and:

- the return is made to the payer of the substitute payment and is not subject to *foreign income tax* (see the Core concepts) or subject to Australian income tax;
- the return is not made to the payer of the substitute payment, but if it had been it would not have been subject to foreign income tax or subject to Australian income tax; or
- if the return were instead made to the payee of the substitute payment:
 - it would be *subject to foreign income tax* (see the Core concepts) or *subject to Australian income tax* (see the Core concepts); or
 - it would give rise to a hybrid mismatch under section 832-495.

[Schedule 1, item 1, subsection 832-510(2)]

1.107 The amount of the hybrid mismatch is the amount of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, subsection 832-510(3)]*

Extended operation of the hybrid financial instrument mismatch rule

1.108 The operation of the hybrid financial instrument mismatch rule is extended so that it also applies if an amount of income or profits was subject to foreign income tax in circumstances where the rate of tax was lower than the ordinary rate of tax that applies to interest income in that jurisdiction.

1.109 In this regard, an amount of income or profits is taken not to be subject to foreign income tax if:

- apart from section 832-515, the amount would be subject to foreign income tax; and
- the rate of foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) (the lower rate) on the amount under the law of the relevant foreign country is lower than the rate (the ordinary rate) that would ordinarily be imposed on interest income derived by an entity of that kind in the foreign country.

[Schedule 1, item 1, subsections 832-515(1) and (2)]

1.110 In these circumstances, in working out whether a deduction/non-inclusion mismatch is attributable to a difference in the treatment of a thing, the deduction/non-inclusion mismatch is taken to be attributable to a difference in the treatment of the thing if the application of the lower rate, instead of the ordinary rate, to the relevant amount is attributable to a difference in the treatment of a thing. *[Schedule 1, item 1, subsections 832-515(3) and (4)]*

1.111 However, for the purpose of working out the amount of the deduction/non-inclusion mismatch that would not arise apart from section 832-515, the amount of a payment that is treated as being subject to foreign tax is to be discounted by multiplying it by the fraction:

$$\frac{\text{Lower rate}}{\text{Ordinary rate}}$$

[Schedule 1, item 1, subsection 832-515(5)]

Consequences that arise if a payment gives rise to a hybrid financial instrument mismatch

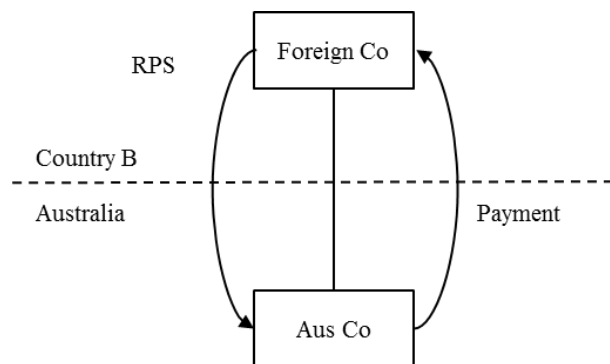
1.112 If a payment gives rise to a hybrid financial instrument mismatch then:

- if Australia is the deducting element of the mismatch — the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction;
- if Australia is the non-including element of the mismatch and the secondary response is required (see subsection 832-935(2)) — the mismatch is neutralised by the

neutralising hybrid mismatch rule for non-including entities (Subdivision 832-C) which operates to include an amount in assessable income; or

- if both deducting and non-including elements are offshore, the mismatch might give rise to an imported hybrid mismatch — the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction.

Example 1.5: Payment gives rise to a hybrid financial instrument mismatch



Aus Co issues 9 year redeemable preference shares to Foreign Co.

Under the terms of the redeemable preference shares, a return (that is, a dividend) accrues daily and is payable upon redemption.

In Australia, the redeemable preference shares are debt interests for income tax purposes and the returns are deductible as they accrue.

Country B has a participation exemption in relation to dividends. Therefore, Aus Co expects that there is a deduction/non-inclusion mismatch that is attributable to the terms of the debt interest.

Therefore, the neutralising provision in section 832-105 applies to disallow the deduction that Aus Co could otherwise claim for the returns as they accrue.

Example 1.6: Payment gives rise to a hybrid financial instrument mismatch — timing

Assume the facts are the same as in Example 1.5, except that Country B does not have a participation exemption for dividends. As a result, the dividends would be taxable in Country B when paid to Foreign Co.

Although Aus Co expects that the dividends would be subject to foreign tax upon redemption, there would be a deduction/non-inclusion mismatch if the redemption date is later than 12 months after the end of the income year in which the deduction arises for Aus Co.

The exception to the hybrid financial instruments rule in subsection 832-500(2) does not apply as the redeemable preference shares have a term of greater than three years.

Therefore, Aus Co's deductions are deferred until the payment of the dividends (section 832-230).

Hybrid payer mismatch (Subdivision 832-J)

What is a hybrid payer mismatch?

1.113 A payment gives rise to a **hybrid payer mismatch** if the payment gives rise to a hybrid mismatch under section 832-575 and either:

- the entity that is the hybrid payer and each entity that is a *liable entity* (see the Core concepts) in respect of the income or profits of the hybrid payer are in the same *Division 832 control group* (see the Core concepts); or
- the scheme under which the payment is made is a *structured arrangement* (see the Core concepts).

[Schedule 1, items 1 and 2, section 832-570 and the definition of 'hybrid payer mismatch' in subsection 995-1(1)]

1.114 However, a payment does not give rise to a hybrid payer mismatch if it gave rise to a hybrid financial instruments mismatch.

[Schedule 1, item 1, section 832-50]

When does a payment give rise to a hybrid mismatch under section 832-575?

1.115 A payment gives rise to a **hybrid mismatch** under section 832-575 if:

- the payment gives rise to a deduction/non-inclusion mismatch; and
- the mismatch, or a part of that mismatch, meets the hybrid requirement in section 832-580.

[Schedule 1, items 1 and 2, subsection 832-575(1) and definition of 'hybrid mismatch' in subsection 995-1(1)]

1.116 The amount of the hybrid mismatch is generally the amount of the deduction/non-inclusion mismatch. [*Schedule 1, item 1, paragraph 832-575(2)(a)*]

1.117 However, if only part of the deduction/non-inclusion mismatch meets the hybrid requirement, the amount of the hybrid mismatch is the amount of that part of the deduction/non-inclusion mismatch. [*Schedule 1, item 1, paragraph 832-575(2)(b)*]

1.118 The amount of the deduction/non-inclusion mismatch is modified if the hybrid payer has an amount of *dual inclusion income* (see the Core concepts) that is available to be applied by section 832-575. The amount of dual inclusion income is applied to reduce (but not below nil) the *Australian income reduction amount* (see the Core concepts) or *foreign income tax deduction* (see the Core concepts) mentioned in subsection 832-920(1) of the definition of deduction/non-inclusion mismatch. [*Schedule 1, item 1, subsections 832-575(3) and (4)*]

1.119 A deduction/non-inclusion mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-580 if the mismatch, or the part of the mismatch, is attributable to the payment that gives rise to the mismatch being made by a hybrid payer. [*Schedule 1, item 1, section 832-580*]

When is an entity a hybrid payer?

1.120 An entity (the test entity) is a ***hybrid payer*** at a time if:

- there are two or more *tax base purposes* (see the Core concepts), for two or more countries, for one or more entities that are *liable entities* (see the Core concepts) in respect of the income of profits of the test entity;
- for one such tax base purpose (the first purpose), the income or profits of the test entity for a period, or part of those income or profits, are taken into account together with the income or profits of one or more other entities (the combined entities);
- for another such tax base purpose, for a different country (the second purpose), the income or profits of the test entity for a period, or part of those income or profits, are:
 - not taken into account together with the income or profits of any other entity; or

- taken into account together with the income or profits of one or more other entities, but those entities are not the same as the combined entities; and
- as a result, a payment made at the time by the test entity to one or more combined entities would be:
 - disregarded for the first purpose; and
 - taken into account for the second purpose.

[Schedule 1, items 1 and 2, subsection 832-585(1) and the definition of ‘hybrid payer’ in subsection 995-1(1)]

1.121 For the purposes of applying section 832-585, income or profits of an entity (the test entity) are not taken into account with income or profits of another entity merely because all or part of the income or profits of the test entity are:

- included under the controlled foreign company provisions (section 456 or 457 of the ITAA 1936) in the assessable income of the other entity; or
- included under a corresponding provision of a law of a foreign country in working out the tax base of that other entity.

[Schedule 1, item 1, subsection 832-585(2)]

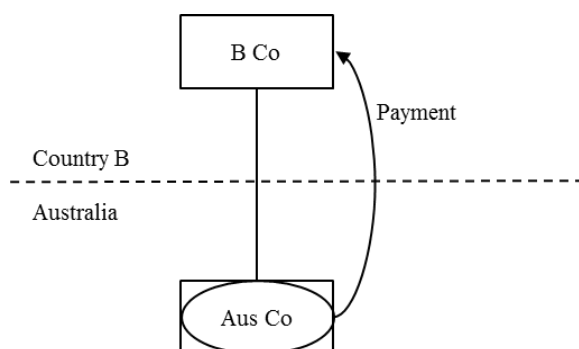
Consequences that arise if a payment gives rise to a hybrid payer mismatch

1.122 If a payment gives rise to a hybrid payer mismatch, then:

- if Australia is the deducting element of the mismatch — the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction;
- if Australia is the non-including element of the mismatch and the secondary response is required (see subsection 832-935(2)) — the mismatch is neutralised by the neutralising hybrid mismatch rule for non-including entities (Subdivision 832-C) which operates to include an amount in assessable income; or
- if both deducting and non-including elements are offshore, the mismatch might give rise to an imported hybrid mismatch

— the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction.

Example 1.7: Payment gives rise to a hybrid payer mismatch — primary response



Aus Co makes a deductible payment to its parent (B Co) for the provision of services.

Country B treats:

- Aus Co as a disregarded entity; and
- the profits of Aus Co as being directly derived by B Co.

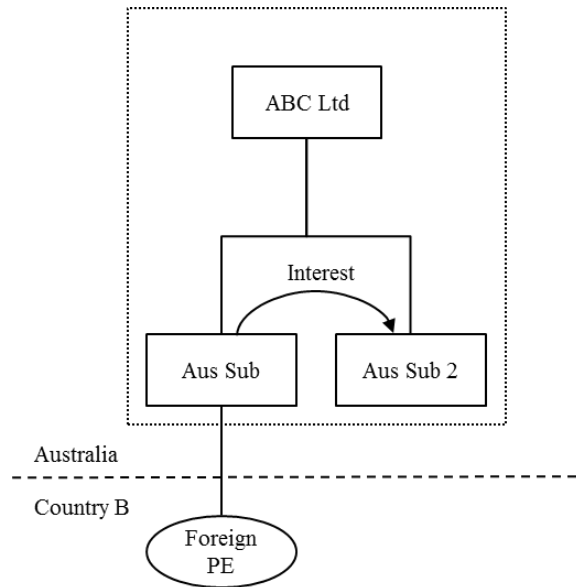
Therefore, both Aus Co and B Co are liable entities in respect of Aus Co's profits as there are tax base purposes:

- in Australia — for Aus Co; and
- in Country B — for B Co.

Aus Co is a hybrid payer because:

- the payment is taken into account, as a deduction, for Australia's tax base purpose; and
- the payment is disregarded for Country B's tax base purpose.

Example 1.8: Payment gives rise to a hybrid payer mismatch — secondary response



Aus Sub and Aus Sub 2 are members of the ABC Ltd consolidated group. Aus Sub:

- has borrowed money from Aus Sub 2 to fund its offshore permanent establishment in Country B; and
- pays interest on the borrowing to Aus Sub 2.

Country B has not implemented any hybrid mismatch rules.

ABC Ltd is a liable entity with a tax base purpose in respect of Aus Sub's profits in Australia (the first purpose). For this purpose, Aus Sub's profits are combined with those of ABC Ltd and Aus Sub 2.

Aus Sub is a liable entity with a tax base purpose in respect of its profits in Country B (the second purpose). For this purpose Aus Sub's profits are not taken into account with the profits of any other entity.

The interest payment by Aus Co is disregarded for the first purpose (under the single entity rule) and taken into account for the second purpose.

Accordingly, Aus Sub is a hybrid payer and should include the amount of the deduction/non-inclusion mismatch in its assessable income.

Reverse hybrid mismatch (Subdivision 832-K)

What is a reverse hybrid mismatch?

1.123 A payment gives rise to a **reverse hybrid mismatch** if the payment gives rise to a hybrid mismatch under section 832-645 and either:

- the following entities are in the same *Division 832 control group* (see the Core concepts):
 - the entity that made the payment;
 - the entity that is the reverse hybrid; and
 - each entity that is an investor identified in paragraph 832-655(b) in relation to the reverse hybrid; or
- the scheme under which the payment is made is a *structured arrangement* (see the Core concepts).

[Schedule 1, items 1 and 2, section 832-640 and the definition of ‘reverse hybrid mismatch’ in subsection 995-1(1)]

1.124 However, a payment does not give rise to a reverse hybrid mismatch if it gave rise to a hybrid financial instruments mismatch or a hybrid payer mismatch. *[Schedule 1, item 1, section 832-50]*

When does a payment give rise to a hybrid mismatch under section 832-645?

1.125 A payment gives rise to a **hybrid mismatch** under section 832-645 if:

- the payment gives rise to a deduction/non-inclusion mismatch; and
- the mismatch, or a part of that mismatch, meets the hybrid requirement in section 832-650.

[Schedule 1, items 1 and 2, subsection 832-645(1) and definition of ‘hybrid mismatch’ in subsection 995-1(1)]

1.126 The amount of the hybrid mismatch is generally the amount of the deduction/non-inclusion mismatch. *[Schedule 1, item 1, paragraph 832-645(2)(a)]*

1.127 An amount included in income under an accruals taxation regime that corresponds to Part X of the ITAA 1936 (the controlled foreign company provisions) will be subject to foreign tax. Accordingly, if an amount is taxed in a parent jurisdiction under a controlled foreign country regime, there would not be a deduction/non-inclusion mismatch for the purposes of the reverse hybrid rule. [Schedule 1, item 1, subsection 832-945(3)]

1.128 However, if only part of the deduction/non-inclusion mismatch meets the hybrid requirement, the amount of the hybrid mismatch is the amount of that part of the deduction/non-inclusion mismatch. [Schedule 1, item 1, paragraph 832-645(2)(b)]

1.129 A deduction/non-inclusion mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-650 if the mismatch, or the part of the mismatch, is attributable to the payment that gives rise to the mismatch being made directly, or indirectly through one or more interposed entities, to a reverse hybrid. [Schedule 1, item 1, section 832-650]

When is an entity a reverse hybrid?

1.130 An entity (the test entity) is a **reverse hybrid**, in relation to a payment, if:

- for a country in which it is formed (the formation country), the test entity is:
 - not a *liable entity* (see the Core concepts); and
 - for Australia — not a member of a consolidated group;
- for the formation country, another entity (an investor) is a liable entity in respect of the income or profits of the test entity, but the payment is not taken into account for the *tax base purpose* (see the Core concepts) for that liable entity;
- for another country (the investor country), either:
 - the investor is a liable entity in respect of the investor's income or profits; or
 - another entity is a liable entity in respect of the investor's income or profits; and
- for the investor country, the liable entity identified in subparagraph 832-655(c)(i) or (ii) is not a liable entity in respect of the income or profits of the test entity, and so the

payment is not taken into account for the tax base purpose for that liable entity; and

- for the investor country, if the payment were instead made directly to the liable entity identified in subparagraph 832-655(c)(i) or (ii):
 - it would be *subject to foreign income tax* (see the Core concepts) or *subject to Australian income tax* (see the Core concepts); or
 - it would give rise to a hybrid mismatch under section 832-495 (about hybrid financial instruments), section 832-575 (about hybrid payers) or section 832-645 (about reverse hybrids).

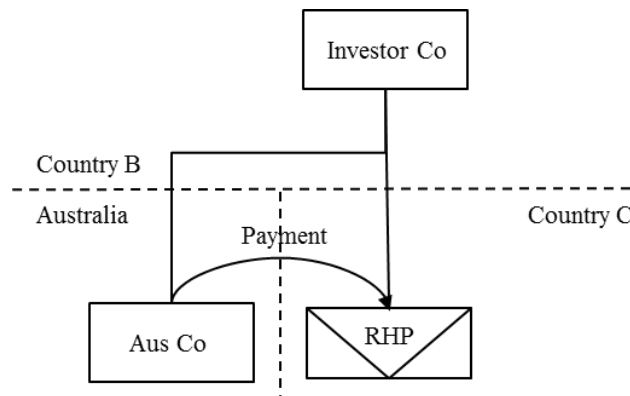
[Schedule 1, items 1 and 2, section 832-655 and the definition of ‘reverse hybrid’ in subsection 995-1(1)]

Consequences that arise if a payment gives rise to a reverse hybrid mismatch

1.131 If a payment gives rise to a reverse hybrid mismatch, then:

- if Australia is the deducting element of the mismatch — the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction; or
- if both deducting and non-including elements are offshore, the mismatch might give rise to an imported hybrid mismatch— in this event, the mismatch is also neutralised by the neutralising hybrid mismatch rule for deducting entities.

Example 1.9: Payment gives rise to a reverse hybrid mismatch



Aus Co makes a deductible payment to a group member, RHP.

RHP is a partnership in Country C. Country C regards Investor Co as the liable entity in respect the payment.

However, Country B regards RHP as a separate liable entity and does not subject the payment to tax in Country B.

If the payment had been made directly by Aus Co to Investor Co, it would have been taken into account for Investor Co's tax base purpose in Country B.

Therefore, RHP is a reverse hybrid and the deductible payment is disallowed for Aus Co.

Deducting hybrid mismatch (Subdivision 832-L)

What is a deducting hybrid mismatch?

1.132 A payment gives rise to a *deducting hybrid mismatch* if:

- the payment gives rise to a hybrid mismatch under section 832-715; and
- if a primary response country is identified in the applicable item in the table in subsection 832-725(2), and that country is not Australia:
 - the exception in subsection 832-710(2) does not apply; and
 - subsection 832-710(3) or (4) does apply.

[Schedule 1, items 1 and 2, subsection 832-710(1) and the definition of 'deducting hybrid mismatch' in subsection 995-1(1)]

1.133 However, a payment does not give rise to a deducting hybrid mismatch if it gave rise to a hybrid financial instruments mismatch, a hybrid payer mismatch or a reverse hybrid mismatch. *[Schedule 1, item 1, section 832-50]*

1.134 The exception in subsection 832-710(2) applies if:

- a *liable entity* (see the Core concepts) in respect of the income or profits of the deducting hybrid satisfies the residency test in subsection 832-725(3) in the primary response country; and

- the primary response country has *foreign hybrid mismatch rules* (see the Core concepts), or another law that has substantially the same effect as foreign hybrid mismatch rules.

[Schedule 1, item 1, subsection 832-710(2)]

1.135 This means that a deducting hybrid mismatch does not arise in Australia where another country has neutralised the hybrid mismatch. This could arise because the investor country has applied the primary response under OECD hybrid mismatch rules, or has existing provisions in their domestic law that have the same effect.

1.136 Subsection 832-710(3) applies if the entity that is the deducting hybrid and each entity that is a liable entity in respect of the income or profits of the deducting hybrid are in the same *Division 832 control group* (see the Core concepts). *[Schedule 1, item 1, subsection 832-710(3)]*

1.137 Subsection 832-710(4) applies if the scheme under which the payment is made is a *structured arrangement* (see the Core concepts). *[Schedule 1, item 1, subsection 832-710(4)]*

When does a payment give rise to a hybrid mismatch under section 832-715?

1.138 A payment gives rise to a *hybrid mismatch* under section 832-715 if:

- the payment gives rise to a deduction/deduction mismatch; and
- the mismatch, or a part of that mismatch, meets the hybrid requirement in section 832-720.

[Schedule 1, items 1 and 2, subsection 832-715(1) and definition of ‘hybrid mismatch’ in subsection 995-1(1)]

1.139 The amount of the hybrid mismatch is generally the amount of the deduction/deduction mismatch. *[Schedule 1, item 1, paragraph 832-715(2)(a)]*

1.140 However, if only part of the deduction/deduction mismatch meets the hybrid requirement, the amount of the hybrid mismatch is the amount of that part of the deduction/deduction mismatch. *[Schedule 1, item 1, paragraph 832-715(2)(b)]*

1.141 The amount of the deduction/deduction mismatch is modified if the deducting hybrid has an amount of *dual inclusion income* (see the Core concepts) that is available to be applied by section 832-715. The

amount of dual inclusion income is applied to reduce (but not below nil) the *Australian income reduction amount* (see the Core concepts) or *foreign income tax deduction* (see the Core concepts) to which the payment gave rise. [Schedule 1, item 1, subsections 832-715(3) and (4)]

1.142 However, if a foreign income tax deduction to be reduced under subsection 832-715(4) represents a share of a net loss of the deducting hybrid for a *foreign tax period* (see the Core concepts), the amount of dual inclusion income is instead applied in reduction (but not below nil) of that net loss, and the foreign income tax deduction is reduced accordingly. [Schedule 1, item 1, subsection 832-715(5)]

1.143 A deduction/deduction mismatch, or a part of such a mismatch, meets the hybrid requirement in section 832-720 if the mismatch, or the part of the mismatch, is attributable to the payment that gives rise to the mismatch being made by a deducting hybrid. [Schedule 1, item 1, section 832-720]

When is an entity a deducting hybrid?

1.144 An entity (the test entity) is a ***deducting hybrid*** at a time if:

- there are *tax base purposes* (see the Core concepts), for two or more countries, for one or more entities that are liable entities in respect of the income or profits of the test entity;
- the test entity satisfies the duplication test in subsection 832-725(2); and
- as a result, a payment made at a time by the test entity would be taken into account for a tax base purpose for two or more different countries.

[Schedule 1, items 1 and 2, subsection 832-725(1) and the definition of ‘*deducting hybrid*’ in subsection 995-1(1)]

1.145 In determining whether an entity (the test entity) satisfies the duplication test in subsection 832-725(2), regard should be had only to the countries for which there are tax base purposes for *liable entities* (see the Core concepts) in respect of the income or profits of the test entity. [Schedule 1, item 1, subsection 832-725(2)]

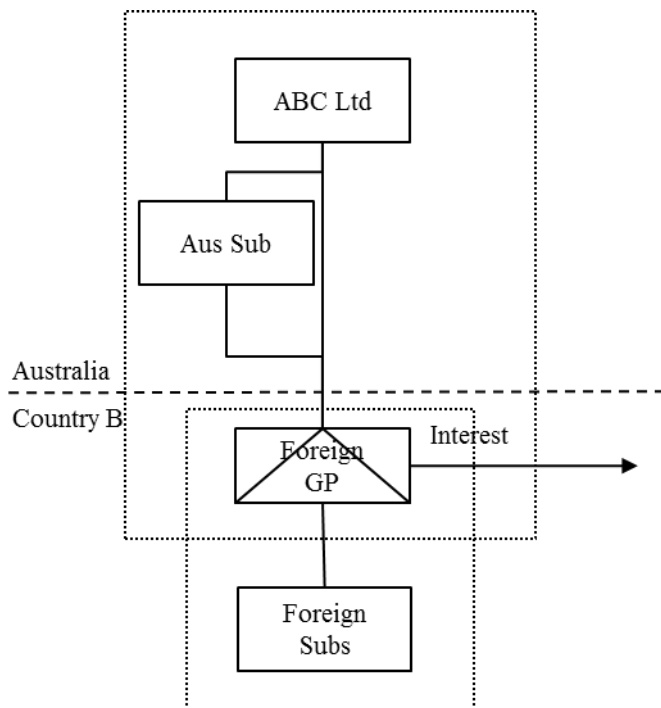
1.146 If there are different liable entities in two or more countries in respect of the income or profits of the test entity, the test entity will satisfy the duplication test if:

- in one country the test entity is either:

- the same entity as the liable entity; or
- a member of a consolidated group; and
- in another country (the primary response country), the liable entity satisfies the residency test.

[Schedule 1, item 1, subsection 832-725(2) (table item 1)]

Example 1.10: Deducting hybrid where Australia is the primary response country



ABC Ltd is the head company of an Australian tax consolidated group. Aus Sub and Foreign general partnership are subsidiary members of the group.

Foreign GP is treated as a corporate entity in Country B and has an external interest expense.

The profits of Foreign GP are taken into account for the tax base purpose of both:

- Foreign GP in Country B; and
- ABC Ltd in Australia.

Foreign GP satisfies the duplication test under item 1 of the table in subsection 832-725(2) because:

- Foreign GP is the liable entity in Country B; and
- Australia is the primary response country.

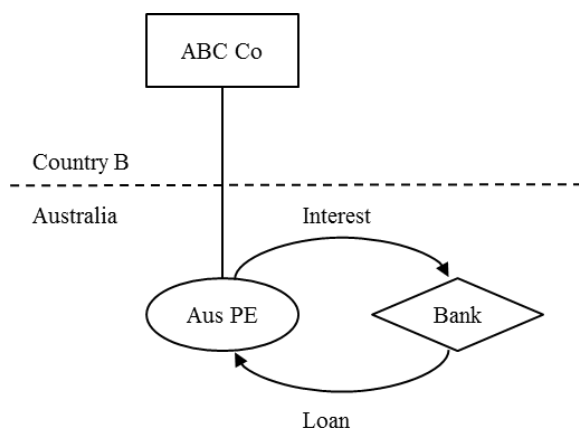
Therefore, Foreign GP is a deducting hybrid.

1.147 If the only liable entity is the test entity, the test entity will satisfy the duplication test if:

- in one country the liable entity does not satisfy the residency test; and
- in another country (the primary response country), the liable entity satisfies the residency test.

[Schedule 1, item 1, subsection 832-725(2) (table item 2)]

Example 1.11: Deducting hybrid where Australia is the secondary response country



ABC Co is a company resident in Country B and has a borrowing attributable to its Australian permanent establishment.

Country B taxes residents on worldwide income. Therefore, the interest is deductible for ABC Co's tax base purpose in both Country B and in Australia.

ABC Co satisfies the duplication test under item 2 of subsection 832-725(2) because it satisfies the residency assumption only in Country B.

Therefore, ABC Co is a deducting hybrid.

Consequently, unless Country B has a rule that has substantially the same effect as the hybrid mismatch rules, Australia would apply the

secondary response to disallow the deduction. The amount disallowed would be reduced to the extent of any dual inclusion income derived by ABC Co.

1.148 If the only liable entity is the test entity, the test entity will also satisfy the duplication test if in all countries, the liable entity satisfies the residency test. *[Schedule 1, item 1, subsection 832-725(2) (table item 3)]*

1.149 This is akin to the dual resident payer rule in the OECD Action 2 Report.

1.150 An entity that is a liable entity in a country satisfies the residency test in relation to the country if:

- if the country is Australia — the entity is an *Australian entity* (as defined in subsection 995-1(1)); or
- if the country is a foreign country — for the tax base purpose for the liable entity for the foreign country:
 - the entity is a resident of the foreign country; or
 - the tax base includes income from worldwide sources.

[Schedule 1, item 1, subsection 832-725(3)]

Extended operation of the deducting hybrid mismatch rule

1.151 The operation of the deducting hybrid mismatch rule is extended so that it also applies in relation to the following amounts in the same way that the rule applies to payments:

- an amount representing the decline in value of an asset; or
- an amount representing a share in the net loss of a partnership, trust or other transparent entity.

[Schedule 1, item 1, subsection 832-730(1)]

1.152 However, these amounts do not give rise to a hybrid financial instruments mismatch, hybrid payer mismatch or reverse hybrid mismatch. *[Schedule 1, item 1, subsection 832-730(2)]*

1.153 For the purpose of the extended application of the deducting hybrid mismatch rule, a reference to the scheme under which the payment is made is taken to be a reference to:

- if the amount represents the decline in value of an asset — the scheme under which the asset is held; or
- if the amount represents a share in the net loss of a partnership, trust or other transparent entity asset — the scheme under which the net loss arose.

[Schedule 1, item 1, subsection 832-730(3)]

Consequences that arise if a payment gives rise to a deducting hybrid mismatch

- 1.154 If a payment gives rise to a deducting hybrid mismatch, then.
- if Australia is the deducting element of the mismatch — the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction; or
 - if both deducting and non-including elements are offshore, the mismatch might give rise to an imported hybrid mismatch — in this event, the mismatch is also neutralised by the neutralising hybrid mismatch rule for deducting entities.

1.155 The neutralising hybrid mismatch rule for non-including entities (Subdivision 832-C) (the secondary response) does not apply to a payment that gives rise to a deducting hybrid mismatch.

Imported hybrid mismatch (Subdivision 832-M)

What is an imported hybrid mismatch?

- 1.156 A payment gives rise to an ***imported hybrid mismatch*** if:
- apart from section 832-105, the payment would give rise to an *Australian income reduction amount* (see the Core concepts) for an entity for an income year;
 - the payment is an importing payment in relation to an offshore hybrid mismatch; and
 - the importing payment is eligible to neutralise the offshore hybrid mismatch.

[Schedule 1, items 1 and 2, subsection 832-785(1) and the definition of 'imported hybrid mismatch' in subsection 995-1(1)]

1.157 However, a payment does not give rise to a imported hybrid mismatch if it gave rise to a hybrid financial instruments mismatch, a hybrid payer mismatch, a reverse hybrid mismatch or a deducting hybrid mismatch. [Schedule 1, item 1, section 832-50]

1.158 An imported hybrid mismatch is also a hybrid mismatch. [Schedule 1, item 1, subsection 832-785(3)]

1.159 The amount of the imported hybrid mismatch is the lesser of:

- the importing deduction amount in relation to the Australian income reduction amount; and
- the amount worked out using the following formula:

$$\frac{\text{Importing deduction}}{\text{Total importing deductions of equal priority}} \times \text{Remaining offshore hybrid mismatch}$$

[Schedule 1, item 1, subsection 832-805(1)]

1.160 In this formula, the factor *Importing deduction* means the amount of the importing deduction amount in relation to the Australian income reduction amount.

1.161 The factor *Total importing deductions of equal priority* means the amount worked out by:

- identifying each importing payment in relation to the offshore hybrid mismatch that is:
 - eligible to neutralise the mismatch; and
 - to which the same item in the table in subsection 832-800(3) applies;
- working out the amount of the importing deduction amount in relation to the Australian income reduction amount or *foreign income tax deduction* (see the Core concepts) to which each such importing payment gives rise; and
- summing the results for each importing payment.

[Schedule 1, item 1, subsection 832-805(1)]

1.162 The amount of the *Remaining offshore hybrid mismatch* is generally the amount of the offshore hybrid mismatch. However, if an item higher in the table in subsection 832-800(3) applies to one or more other importing payments in relation to the offshore hybrid mismatch, the amount is the amount of the offshore hybrid mismatch that is not, or will not, be neutralised by the application of the imported hybrid mismatch rule, and equivalent provisions of applicable *foreign hybrid mismatch rules* (see the Core concepts), in relation to those other importing payments. [Schedule 1, item 1, subsection 832-805(1)]

1.163 The amount of the *importing deduction amount* in relation to an Australian income reduction amount or foreign income tax deduction is:

- if the importing payment is made directly to the offshore deducting entity — the amount of the Australian income reduction amount or foreign income tax deduction; or
- if the importing payment is made indirectly through one or more interposed entities to the offshore deducting entity — the lesser of:
 - the amount of the Australian income reduction amount or foreign income tax deduction; and
 - the smallest amount of any foreign income tax deduction to which a payment to an interposed entity gave rise.

[Schedule 1, item 1, subsection 832-805(2)]

When does a payment give rise to an offshore hybrid mismatch?

1.164 A payment an entity (the offshore deducting entity) makes gives rise to an *offshore hybrid mismatch* if:

- the payment gives rise to a hybrid financial instruments mismatch, a hybrid payer mismatch, a reverse hybrid mismatch or a deducting hybrid mismatch;
- the payment gave rise to a foreign income tax deduction for an entity for a *foreign tax period* (see the Core concepts) (the deducting period);
- the payment did not give rise to an Australian income reduction amount for any entity; and

- no amount was included in an entity's assessable income under section 832-165 (which is about neutralising mismatches for non-including entities) in respect of the hybrid mismatch.

[Schedule 1, items 1 and 2, subsection 832-790(1) and the definition of 'offshore hybrid mismatch' in subsection 995-1(1)]

1.165 For the purposes of working out whether a payment gives rise to an Australian income reduction amount, the effect of Subdivision 832-B (which is about neutralising mismatches for deducting entities) is disregarded. *[Schedule 1, item 1, subsection 832-790(2)]*

1.166 The amount of the offshore hybrid mismatch is the amount of the hybrid mismatch to which the payment gives rise. *[Schedule 1, item 1, subsection 832-790(3)]*

What is an importing payment?

1.167 A payment an entity (the payer) makes is an ***importing payment*** in relation an offshore hybrid mismatch if the payment is made directly, or indirectly through one or more interposed entities, to the offshore deducting entity. *[Schedule 1, items 1 and 2, subsection 832-795(1) and the definition of 'importing payment' in subsection 995-1(1)]*

1.168 However, a payment is not an importing payment if the income or profits of the offshore deducting entity, or an interposed entity, are:

- *subject to Australian income tax* (see the Core concepts); or
- *subject to foreign income tax* (see the Core concepts) in a country that has *foreign hybrid mismatch rules* (see the Core concepts).

[Schedule 1, item 1, subsection 832-795(2)]

1.169 In determining if a payment is made indirectly through an interposed entity to an offshore deducting entity, it is not necessary to demonstrate that each payment funds another. It is sufficient that payments exist between each interposed entity. However, the payments must be tax neutral (that is, assessable and deductible).

1.170 For the purposes of determining whether a payment is made indirectly through one or more interposed entities to the offshore deducting entity:

- it is not necessary to demonstrate that each payment in a series of payments funds the next payment, or is made after the previous payment; and
- it is sufficient if payments exist between each interposed entity, and each of the payments give rise to a foreign income tax deduction (but not a deduction/non-inclusion mismatch).

[Schedule 1, item 1, subsection 832-795(3)]

When is an importing payment eligible to neutralise an offshore hybrid mismatch?

1.171 An importing payment an entity makes is eligible to neutralise an offshore hybrid mismatch if:

- the payment, or part of the payment, gives rise to:
 - an Australian income reduction amount in an income year covered by subsection 832-800(2); or
 - a foreign income tax deduction, in a foreign country that has foreign hybrid mismatch rules, in a foreign tax period covered by subsection 832-800(2); and
- an item in the table in subsection 832-800(3) applies to the importing payment.

[Schedule 1, item 1, subsection 832-800(1)]

1.172 A foreign tax period or income year is covered by subsection 832-800(2) if (and only if):

- it ends at or after the end of the deducting period mentioned in paragraph 832-790(1)(b) — that is, at or after the end of the foreign tax period in which the payment made by the offshore deducting entity gave rise to a foreign income tax deduction; and
- it has at least one day in common with the deducting period.

[Schedule 1, item 1, subsection 832-800(2)]

1.173 Table 1.1 sets out priority rules for importing payments. If more than one item in the table covers an importing payment, the first item that covers it applies. However, an item does not apply if:

- an item higher in the table applies to one or more other importing payments in relation to the offshore hybrid mismatch; and
- the offshore hybrid mismatch is, or will be, fully neutralised by the application of the imported hybrid mismatch rule, and equivalent provisions of applicable foreign hybrid mismatch rules to those other importing payments.

[Schedule 1, item 1, subsection 832-800(3)]

Table 1.1: Priority table for importing payments

<i>Item</i>	<i>Topic</i>	<i>An importing payment is covered if:</i>
1	<i>Structured arrangement</i> (see the Core concepts)	<ul style="list-style-type: none"> • the importing payment, the payment made by the offshore deducting entity, and each payment made by the interposed entity (if applicable) are made under a structured arrangement; and • the payer of the importing payment, the offshore deducting entity, and each interposed entity (if applicable) are all parties to the structured arrangement
2	Direct payment	<ul style="list-style-type: none"> • the importing payment is made directly to the offshore deducting entity; and • the payer of the importing payment and the offshore deducting entity are members of the same <i>Division 832 control group</i> (see the Core concepts)
3	Indirect payment	<ul style="list-style-type: none"> • the importing payment is made indirectly through one or more interposed entities to the offshore deducting entity; and • the payer of the importing payment, the offshore deducting entity and each interposed entity are members of the same <i>Division 832 control group</i>

[Schedule 1, item 1, subsection 832-800(3)]

Consequences that arise if a payment gives rise to an imported hybrid mismatch

1.174 If a payment gives rise to an imported hybrid mismatch, then the mismatch is neutralised by the neutralising hybrid mismatch rule for deducting entities (Subdivision 832-B) which operates to deny a deduction.

1.175 The neutralising hybrid mismatch rule for non-including entities (Subdivision 832-C) (the secondary response) does not apply to a payment that gives rise to an imported hybrid mismatch.

Core concepts relating to the operation of the hybrid mismatch rules

Australian income reduction amount

1.176 An amount is an *Australian income reduction amount* for an entity in an income year if it is:

- an amount that the entity can *deduct* (as defined in subsection 995-1(1)) in the income year, other than a net amount that is deductible because it is an element in the calculation of a net amount (that is covered by paragraph 832-930(c)(i));
- an amount that:
 - is an element in the calculation of a net amount included in the entity’s assessable income (other than under Division 102 (as a net capital gain), Division 5 of Part III of the ITAA 1936 (as net income of a partnership) or Division 6 of Part III of the ITAA 1936 (as net income of a trust)) for the entity for the income year; and
 - has the effect of reducing the amount so included; or
- an amount that:
 - is an element in the calculation of a net amount that is deductible (other than under Division 5 of Part III of the ITAA 1936 (as a net loss of a partnership)) for the entity for the income year; and
 - has the effect of increasing the amount so deducted.

[Schedule 1, items 1 and 2, subsection 832-930(1) and the definition of ‘Australian income reduction amount’ in subsection 995-1(1)]

1.177 In this regard, paragraphs 832-930(b) and (c) have the effect of ensuring that an element in the calculation of a net amount which reduces the amount of assessable income is treated as an Australian income reduction amount because it is akin to a deduction.

1.178 For example, the Taxation of Financial Arrangement provisions (Division 230) operate to:

- include a net gain on a financial arrangement in assessable income; or
- allow a deduction for a net loss on a financial arrangement.

1.179 The element in the calculation of the net gain or loss that reduces the gross amount is an Australian income reduction amount.

Division 832 control group

1.180 Two entities are in the same ***Division 832 control group*** if:

- the entities are both members of a group of entities that are consolidated for accounting purposes as a single group;
- one of the entities holds a total participation interest of 50 per cent or more in the other entity; or
- a third entity holds a total participation interest of 50 per cent or more in each of the entities.

[Schedule 1, items 1 and 2, section 832-1015 and the definition of ‘Division 832 control group’ in subsection 995-1(1)]

Dual inclusion income

1.181 An amount of income or profits of an entity that is a hybrid payer or a deducting hybrid is ***dual inclusion income*** of the entity if two or more of the following apply to the amount:

- it is subject to Australian income tax in income year;
- it is subject to foreign income tax in a foreign country in a foreign tax period; or
- it is subject to foreign income tax in another foreign country in a foreign tax period.

[Schedule 1, items 1 and 2, subsection 832-1020(1) and the definition of ‘dual inclusion income’ in subsection 995-1(1)]

1.182 An amount of income or profits that is, broadly, entitled to a foreign tax credit (other than for a withholding type tax) is not dual inclusion income because it is not an amount that is subject to Australian income tax or subject to foreign income tax. *[Schedule 1, item 1, subsection 832-940(2) and 832-945(2)]*

1.183 For the purposes of working out whether an amount is dual inclusion income, an amount of income or profits of an entity is treated as though it were subject to Australian income tax in an income year if:

- the entity is a member of a consolidated group;
- the payment is received from another member of the consolidated group;
- it is reasonable to conclude that the payment was funded by another amount of income or profits of the other member (the funding payment); and
- the funding payment was subject to Australian income tax because it was included in the head company's assessable income for the income year.

[Schedule 1, item 1, subsection 832-1020(2)]

1.184 An amount of dual inclusion income is available to be applied by a provision of Division 832 to reduce an amount if:

- for an amount that is an Australian income reduction amount for an income year — the dual inclusion income is subject to Australian income tax in the income year; or
- for an amount that is a foreign income tax deduction, or a net loss mentioned in subsection 832-715(5), in a foreign country, for a foreign tax period — the dual inclusion income is subject to foreign income tax in the foreign tax period.

[Schedule 1, item 1, subsection 832-1020(3)]

1.185 An amount of dual inclusion income is available to be applied by section 832-235 to create an adjustment for an entity in an income year if the dual inclusion income is subject to Australian income tax in the income year. That is, an amount of dual inclusion income which arises in a later income year can be used to generate a deduction from the amount of the hybrid mismatch disallowed in the earlier income year. *[Schedule 1, item 1, section 832-235 and subsection 832-1020(4)]*

1.186 An amount of dual inclusion income is not available to be applied by a provision of Division 832 if the amount has already been applied by a previous application of a provision of the Division.

[Schedule 1, item 1, subsection 832-1020(5)]

Foreign hybrid mismatch rules

1.187 **Foreign hybrid mismatch rules** are rules under a foreign law that correspond to Australia's hybrid mismatch rules in Division 832. [Schedule 1, item 2, definition of 'foreign hybrid mismatch rules' in subsection 995-1(1)]

1.188 In this regard, a foreign law will correspond to Australia's hybrid mismatch rules in Division 832 only if that law is consistent with the effect of the recommendations of the OECD Action 2 Report.

Foreign income tax deduction

1.189 An amount of a loss or outgoing incurred by an entity is a **foreign income tax deduction** in a foreign country in a foreign tax period to which an entity is entitled if:

- the amount is deducted in working out the tax base of the entity under a law of the foreign country for the foreign tax period; and
- as a result, the amount of foreign income tax (other than *credit absorption tax* (as defined in subsection 995-1(1)), *unitary tax* (as defined in subsection 995-1(1)) or a withholding-type tax) payable under a tax law of the foreign country is reduced.

[Schedule 1, items 1 and 2, subsection 832-935(1) and the definition of 'foreign income tax deduction' in subsection 995-1(1)]

1.190 An amount is taken to be deducted in working out the tax base of an entity under a law in the foreign country for the foreign tax period if it is applied to reduce the amount of tax payable by the entity in the foreign country in any way. This could include, for example:

- an amount that specifically reduces the amount of tax payable by the entity in the foreign country (akin to an amount that is a deduction under the Australian income tax law); or
- an amount that is an element in the calculation by the entity of a net amount that is included in the tax base under the law in the foreign country.

1.191 In determining whether an amount is deducted in working out the tax base of the entity under a law of the foreign country for the foreign tax period, regard should be had to the effect of any foreign hybrid

mismatch rules that correspond to the Australian primary response provisions. [Schedule 1, item 1, paragraph 832-935(2)(a)]

1.192 The Australian primary response provisions are:

- Subdivision 832-B (which has the effect of neutralising the hybrid mismatch in a foreign country by denying the deduction in that country), to the extent that the Subdivision applies in relation to a deduction/non-inclusion mismatch or an imported hybrid mismatch; and
- Subdivision 832-B, to the extent that the Subdivision applies in relation to a deduction/deduction mismatch if a primary response country is identified in the applicable item of the table in subsection 832-725(2), and that country is Australia.

[Schedule 1, item 1, subsection 832-935(3)]

1.193 In addition, in determining whether an amount is deducted in working out the tax base of the entity under a law of the foreign country for the foreign tax period, the effect of any foreign hybrid mismatch rules that correspond to the Australian secondary response provisions (for deductions) should be disregarded. [Schedule 1, item 1, paragraph 832-935(2)(b)]

1.194 The Australian secondary response provisions (for deductions) are Subdivision 832-B, to the extent that the Subdivision applies in relation to a deduction/deduction mismatch if a primary response country is identified in the applicable item of the table in subsection 832-725(2), and that country is not Australia. [Schedule 1, item 1, subsection 832-935(4)]

Foreign tax period

1.195 A **foreign tax period**, in relation to an entity, in relation to a foreign tax imposed by a tax law of a foreign country, means the accounting period used by the entity for the purposes of determining the tax base under that law. [Schedule 1, item 2, definition of 'foreign tax period' in subsection 995-1(1)]

Liable entity

1.196 An entity is a **liable entity**, in a country, in respect of the income or profits of an entity (the test entity) if:

- for Australia — *tax* (as defined in subsection 995-1(1)) is imposed on the entity in respect of the income or profits of the test entity for an income year; and

- for a foreign country — *foreign income tax* (as defined in subsection 995-1(1)) (other than credit absorption tax, unitary tax or a withholding-type tax) is imposed under the law of a foreign country on the entity in respect of the income or profits of the test entity for a foreign tax period.

[Schedule 1, items 1 and 2, subsection 832-1000(1) and the definition of ‘liable entity’ in subsection 995-1(1)]

1.197 In this regard, there may be one or more interposed entities between the test entity and an entity that is a liable entity in respect of the income or profits of the test entity. *[Schedule 1, item 1, subsection 832-1000(2)]*

1.198 Generally, a non-transparent entity (such as a company) is a liable entity. However, a transparent entity (such as a trust or partnership) or disregarded entity (such as a member of a consolidated group) is not a liable entity.

1.199 For the purposes of determining whether a test entity is a liable entity, section 832-1000 considers whether tax is imposed on the income or profits of the test entity of the particular type, rather than on the actual circumstances of a particular entity in a particular income year. Therefore, if, for example, a test entity is an entity of a type that is normally subject to tax but has a tax loss for a particular income year (and therefore has no tax liability in that particular income year), the test entity will still be a liable entity.

Party to a structured arrangement

1.200 An entity that entered into or carried out the scheme or any part of the scheme is a ***party*** to a structured arrangement unless:

- the entity could not reasonably have been expected to be aware that the scheme gave rise to a hybrid mismatch;
- no other entity in the same Division 832 control group as the entity could reasonably have been expected to be aware that the scheme gave rise to a hybrid mismatch; and
- the financial position of each entity in the Division 832 control group as the entity would reasonably be expected to have been the same if the scheme had not given rise to the hybrid mismatch.

[Schedule 1, items 1 and 2, subsection 832-1010(3) and the definition of ‘party’ in subsection 995-1(1)]

Structured arrangement

1.201 A scheme under which a payment is made is a ***structured arrangement*** if the payment gives rise to a hybrid mismatch and either:

- the hybrid mismatch is priced into the terms of the scheme; or
- it is reasonable to conclude that the scheme has been designed to produce a hybrid mismatch.

[Schedule 1, items 1 and 2, subsection 832-1010(1) and the definition of ‘structured arrangement’ in subsection 995-1(1)]

1.202 The question whether a scheme has been designed to produce a hybrid mismatch must be determined by reference to the facts and circumstances that exist in connection with the scheme, including the terms of the scheme. *[Schedule 1, item 1, subsection 832-1010(2)]*

Subject to Australian income tax

1.203 An amount of income or profits is ***subject to Australian income tax*** in an income year if:

- the amount is included in working out the taxable income of an entity (other than a trust or partnership) for the income year; or
- the amount is included in working out:
 - for a trust — the net income for the income year; or
 - for a partnership — the net income or partnership loss for the income year.

[Schedule 1, items 1 and 2, subsection 832-940(1) and the definition of ‘subject to Australian income tax’ in subsection 995-1(1)]

1.204 In this regard, an amount of income or profits of an entity is taken to be subject to Australian income tax if the amount is included in the assessable income of another entity under the controlled foreign company regime (section 456 and 457 of the ITAA 1936). *[Schedule 1, item 1, subsection 832-940(3)]*

1.205 However, an amount of income or profits is taken to be not subject to Australian income tax if an amount of foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) paid in is payable in respect of the amount counts towards a tax offset for an entity

under Division 770 (the foreign income tax offset rules). *[Schedule 1, item 1, subsection 832-940(2)]*

Subject to foreign income tax

1.206 An amount of income or profits is ***subject to foreign income tax*** in a foreign country in a foreign tax period if:

- the amount is included in the tax base of a law of the foreign country for the foreign tax period; and
- as a result, the amount is taken into account in working out the amount (including a nil amount) of foreign income tax (other than credit absorption tax, unitary tax or a withholding-type tax) payable by an entity for the foreign tax period.

[Schedule 1, items 1 and 2, section 832-945 and the definition of ‘subject to foreign income tax’ in subsection 995-1(1)]

1.207 In this regard, an amount of income or profits of an entity is taken to be subject to foreign income tax if the amount is included in working out the tax base of another entity under a provision of a law of a foreign country that corresponds to Australia’s controlled foreign company regime (Part X of the ITAA 1936). *[Schedule 1, item 1, subsection 832-945(3)]*

1.208 However, an amount of income or profits is taken to be not subject to foreign income tax if an entity is entitled under the law of a foreign country to a credit, rebate or other tax concession in respect of the amount for foreign tax (other than a withholding-type tax) payable under a tax law of a different country (including Australia). *[Schedule 1, item 1, subsection 832-945(2)]*

1.209 In determining whether a payment is included in a tax base of a law of a foreign country, provisions of foreign hybrid mismatch rules that correspond to the Australian secondary response provisions (for non-inclusion) should be disregarded. The Australian secondary response provisions (for non-inclusion) are Subdivision 832-C, which have the effect of neutralising the hybrid mismatch by including an amount in assessable income. *[Schedule 1, item 1, subsections 832-945(4) and (5)]*

1.210 This will ensure that, where Australia has the right to neutralise a hybrid mismatch by applying the Australian primary response provisions in Subdivision 832-B to deny a deduction, the fact that a foreign country may have sought to deny the hybrid mismatch by applying the OECD Action 2 Report secondary response rule to include an amount in assessable income is disregarded.

Tax base purpose

1.211 A purpose is a ***tax base purpose***, for a country, for a liable entity if:

- for Australia — working out, under the Australian income tax law:
 - the taxable income of the liable entity for an income year; or
 - if tax is imposed on the liable entity in respect of an amount other than taxable income — that other amount;
- for a foreign country — working out, under the law of a foreign country, the tax base of the liable entity for a foreign tax period.

[Schedule 1, items 1 and 2, section 832-1005 and the definition of ‘tax base purpose’ in subsection 995-1(1)]

Application and transitional provisions

1.212 The amendments to implement the OECD hybrid mismatch rules apply to payments made on or after the day that is six months after the day that this Bill receives the Royal Assent. *[Schedule 1, item 3, section 832-10 of the Income Tax (Transitional Provisions) Act 1997]*

1.213 A term that is defined in Part 2 of Schedule 1 (which inserts various definitions into the ITAA 1997) applies in a provision of an Act, regulation or instrument in the same way as that provision applies. *[Schedule 1, item 4]*

Chapter 2

Other effects of foreign income tax deductions

Outline of chapter

- 2.1 Schedule 2 to this Exposure Draft Bill amends the ITAA 1997 to:
- deny imputation benefits on franked distributions made by a Australian corporate tax entity if the entity was entitled to a foreign income tax deduction in respect of all or part of the distribution; and
 - prevent certain foreign equity distributions received, directly or indirectly, by an Australian corporate tax entity from being non-assessable non-exempt income if the foreign company that made the distribution was entitled to a foreign income tax deduction in respect of the distribution.
- 2.2 All references in this chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

- 2.3 In the 2016-17 Budget, the Government announced that it would implement the recommendations made in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation (see Chapter 1). These recommendations include modifications to the domestic income tax law to:
- deny imputation benefits on franked distributions made by a Australian corporate tax entity if the entity was entitled to a foreign income tax deduction in respect of all or part of the distribution; and
 - prevent certain foreign equity distributions received, directly or indirectly, by an Australian corporate tax entity from being non-assessable non-exempt income if the foreign company that made the distribution was entitled to a foreign income tax deduction in respect of the distribution.

2.4 In the 2017-18 Budget, the Government further announced that it would eliminate hybrid tax mismatches that occur in cross border transactions relating to Additional Tier 1 regulatory capital, including transitional rules for Additional Tier 1 capital instruments issued before 9 May 2017.

Summary of new law

2.5 Consistent with the OECD Action 2 Report and Board of Taxation recommendations, Schedule 2 to this Exposure Draft Bill makes amendments to:

- deny imputation benefits on franked distributions made by a Australian corporate tax entity if the entity was entitled to a foreign income tax deduction in respect of all or part of the distribution; and
- prevent a foreign equity distribution from a foreign company that is received, directly or indirectly, by an Australian corporate tax entity that holds a participation interest of at least 10 per cent in the foreign company from being non-assessable non-exempt income if the foreign company that made the foreign equity distribution was entitled to a foreign income tax deduction in respect of the distribution.

2.6 Transitional rules apply to Additional Tier 1 capital instruments issued by authorised deposit-taking institutions before 9 May 2017. Under these transitional rules, the amendments to deny imputation benefits do not apply in relation to distributions on the instrument that are made before the first available call date of the instrument that occurs on or after 9 May 2017.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
An entity that receives a franked distribution is denied access to imputation benefits if the Australian corporate tax entity that made the distribution was entitled to a foreign income tax deduction in respect of all or part of the distribution.	Under the company imputation system, when an Australian corporate tax entity distributes profits to its members, the entity has the option of passing credit for income tax paid by the entity on those profits to those members. This is done by franking the distribution.

	<p>When the Australian corporate tax entity makes a franked distribution, the entity must make a debit to its franking account. The amount of the debit is equal to the amount of the franking credit on the distribution.</p> <p>If a member of an entity receives a franked distribution:</p> <ul style="list-style-type: none"> • an amount equal to the amount of the franking credit is generally included in the member's assessable income (in addition to the amount of the distribution); and • the member is generally entitled to a tax offset equal to the amount of the franking credit.
<p>A foreign equity distribution from a foreign company that is received by an Australian corporate tax entity, either directly or indirectly through one or more interposed trusts or partnerships, is generally non-assessable non-exempt income if the Australian corporate tax entity holds a participation interest of at least 10 per cent in the foreign company.</p> <p>However, if the foreign company that made the foreign equity distribution was entitled to a foreign income tax deduction in respect of the distribution, then the distribution will not be non-assessable non-exempt income.</p> <p>In this event, foreign equity distribution will be included in the assessable income of the Australian corporate tax entity.</p>	<p>A foreign equity distribution from a foreign company that is received by an Australian corporate tax entity, either directly or indirectly through one or more interposed trusts or partnerships, is non-assessable non-exempt income if the Australian corporate tax entity holds a participation interest of at least 10 per cent in the foreign company.</p>

Detailed explanation of new law

Denial of imputation benefits

2.7 Consistent with the OECD Action 2 Report and the Board of Taxation recommendations, Schedule 2 to this Exposure Draft Bill makes amendments to deny imputation benefits on franked distributions made by a corporate tax entity that give rise to a foreign income tax deduction.

2.8 Under the company imputation system, when an Australian corporate tax entity distributes profits to its members, the entity has the option of passing credit for income tax paid by the entity on those profits to those members. This is done by franking the distribution.

2.9 When the Australian corporate tax entity makes a franked distribution, the entity must make a debit to its franking account (section 205-30). The amount of the debit is equal to the amount of the franking credit on the distribution.

2.10 If a member of an entity receives a franked distribution:

- an amount equal to the amount of the franking credit is generally included in the member's assessable income (in addition to the amount of the distribution); and
- the member is generally entitled to a tax offset equal to the amount of the franking credit.

2.11 The amendments operate to deny these imputation benefits if the Australian corporate tax entity that made the distribution was entitled to a *foreign income tax deduction* (see the Core concepts in Chapter 1) in respect of all or part of the distribution. [*Schedule 2, items 1 to 3, paragraph 207-145(1)(da), paragraph 207-150(2)(eb) and section 207-158*]

2.12 Subject to transitional rules, these amendments address the announcement in the 2017-18 Budget relating to the application of the OECD Hybrid Mismatch Rules to Regulatory Capital (even though the amendments are not limited to regulatory capital).

Transitional rules for regulatory capital

2.13 The transitional rules for regulatory capital apply if:

- before 9 May 2017, an authorised deposit-taking institution issued an Additional Tier 1 capital instrument (within the meaning of the prudential standards, as in force at the time that this Schedule commences); and

- the instrument is callable, and there is an available call date of the instrument on or after 9 May 2017.

[Schedule 2, subitem 8(1)]

2.14 The *prudential standards* are defined in subsection 995-1(1) to mean the prudential standards determined by the Australian Prudential Regulation Authority and in force under section 11AF of the *Banking Act 1959*.

2.15 In these circumstances, the amendments do not apply in relation to distributions on the instrument that are made before the first available call date of the instrument that occurs on or after 9 May 2017. *[Schedule 2, subitem 8(2)]*

Foreign equity distributions assessable

2.16 Consistent with the OECD Action 2 Report and the Board of Taxation recommendations, Schedule 2 to this Exposure Draft Bill makes amendments to ensure that foreign equity distributions that are entitled to a foreign income tax deduction are included in a corporate tax entity's assessable income.

2.17 In this regard, a foreign equity distribution from a foreign company that is received by an Australian corporate tax entity, either directly or indirectly through one or more interposed trusts or partnerships, is non-assessable non-exempt income if the Australian corporate tax entity holds a participation interest of at least 10 per cent in the foreign company (Subdivision 768-A).

2.18 The amendments ensure that, if the foreign company that made the foreign equity distribution was entitled to a *foreign income tax deduction* (see the Core concepts in Chapter 1) in respect of the distribution, then the distribution will not be non-assessable non-exempt income. *[Schedule 2, items 4 to 7, paragraph 768-5(1)(d), paragraph 768-5(2)(f) and section 768-7]*

2.19 Consequently, in this event, foreign equity distribution will be included in the assessable income of the Australian corporate tax entity.

Application and transitional provisions

Denial of imputation benefits

2.20 Subject to transitional rules for regulatory capital of authorised deposit-taking institutions, the amendments to deny imputation benefits apply to distributions made on or after the day that is six months after the day that this Bill receives the Royal Assent. *[Schedule 2, subitem 7(1)]*

2.21 However, under the transitional rules for regulatory capital of authorised deposit-taking institutions, the amendments do not apply in relation to distributions on an Additional Tier 1 capital instrument issued before 9 May 2017, where those distributions are made before the first available call date of the instrument that occurs on or after 9 May 2017. *[Schedule 2, item 8]*

Foreign equity distributions assessable

2.22 The amendments to make foreign equity distributions assessable apply to foreign equity distributions made on or after the day that is six months after the day that this Bill receives the Royal Assent. *[Schedule 2, subitem 7(2)]*

