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The Manager
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The Treasury
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By e-mail: BEPS@Treasury.gov.au

Attention: Mr William Potts

Dear William

Hybrid Mismatch Rules

Deloitte welcomes the opportunity to comment on the exposure draft legislation "*Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017*" (**ED**) released by the Federal Government on 24 November 2017.

As a preliminary comment, we note that the ED is generally in line with our expectations and therefore, our submissions below (except in relation to the proposed targeted integrity rule) relate to a small number of specific issues.

1 Commencement date

As currently drafted, the proposed rules (including, according to the Media Release announcing the ED, the proposed targeted integrity rule and branch mismatch rules) would commence 6 months after Royal Assent, and taxpayers will not benefit from grandfathering relief.

For the following reasons, we submit that the commencement date should be the earlier of 1 January or 1 July following the date that is 6 months after Royal Assent.

Although we appreciate that the ED in many respects accords with OECD recommendations published in 2015, the ED nevertheless addresses a complex subject matter specifically in the Australian context, potentially with very broad scope, and adds many new and untested concepts to Australian tax law. The ED Explanatory Memorandum as presently drafted leaves certain material questions unanswered (e.g. clarification of concepts relating to imported mismatches, which potentially are very far reaching), making it difficult to apply these new concepts. The ED materials do not yet include details of consequential amendments or address the interaction of the proposed rules with other areas of the law (e.g. thin capitalisation rules and controlled foreign company ("**CFC**") rules). We also understand that ATO guidance may not be finalised for some time and may only address select areas (i.e. structured arrangements, the imported mismatch rule, and the application of Part IVA to restructures to avoid the application of the hybrid mismatch rules).

In determining an appropriate commencement date, it is important to recognise that taxpayers require sufficient time to properly consider the potential application of the proposed rules to their funding and operational structures and the associated tax, financial reporting, legal and treasury issues that may arise – including the potential need to refinance or restructure existing arrangements (where possible). In the present circumstances, certain material components of the proposed rules, including the targeted integrity rule and the branch mismatch rules, are still under development. The targeted integrity rule, in particular, will be vital to taxpayers' analyses of appropriate responses to the proposed measures.

In its report to Government "Implementation of the OECD hybrid mismatch rules"[1], the Board of Taxation suggested that the draft legislation be released at least 12 months in advance of the proposed commencement date to allow time for further analysis of the potential impact of the rules and consultation on the detailed design of the rules.

In these circumstances we submit that the commencement date proposed above, i.e. the earlier of 1 January or 1 July following the date that is 6 months after Royal Assent, should afford taxpayers greater opportunity to assess the potential impact of these complex new rules (integral components of which remain under development), contribute to the consultation process and consider and implement appropriate responses taking into account any applicable integrity measures, without imposing undue administrative or compliance burdens.

It is also important that the choice of commencement date does not unduly or arbitrarily burden taxpayers seeking to comply with the new rules and to reflect new arrangements (or reflect new tax consequences of existing arrangements) in their finance and other systems. Some existing arrangements with third parties will be unable to be restructured by the applicable commencement date and affected taxpayers will need to apply the rules to those arrangements. A 1 January or 1 July start date which aligns with typical reporting periods would reduce the complexity and compliance costs associated with applying the rules to parts of a reporting period (which may be the case under the current proposal where Royal Assent could occur part way through a calendar month).

2 Targeted integrity rule

The Media Release stated that the Government will legislate a targeted integrity rule aimed at arrangements implemented to circumvent the hybrid mismatch rules. The example provided in the Media Release is:

> "*foreign headquartered groups investing into Australia may use financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax.*"

An integrity rule which departs significantly from the OECD's Base Erosion and Profit Shifting framework is an unexpected development and will cause additional uncertainty in relation to existing and new arrangements.

We note that the integrity rule goes beyond the scope of the OECD's recommendations. To the extent that it addresses situations which have no element of hybridity, the integrity rule would seem to involve a fundamental policy change as it would be altering the Australian tax outcome for the taxpayer based on the treatment of the counterparty to the arrangement under a foreign tax regime. It is difficult to see why such outcomes are unacceptable in the context of financing arrangements but not other arrangements or

[1] Board of Taxation, "Implementation of the OECD hybrid mismatch rules", March 2016, at paragraph 3.10

to discern a coherent policy rationale for this approach. We submit that such a policy shift requires substantive consideration and consultation in a broader context than is currently the case.

In light of the above, we submit that the targeted integrity rule should be limited to one that preserves the effectiveness of the hybrid mismatch measures. As such, it should only apply in circumstances where there would be a hybrid mismatch, but for interposition of the relevant vehicle in the zero tax jurisdiction. We would welcome the opportunity to provide further comments on the targeted integrity rule once more detail becomes available.

3 Interaction with other rules

3.1 Thin capitalisation

As currently drafted, the ED does not address the interaction of the proposed rules with the thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997 (Cth)* (**1997 Act**). The implication is that a debt deduction may be disallowed under the hybrid mismatch rules in circumstances where the debt to which the deduction relates is nevertheless included in the adjusted average debt calculation.

We submit that where a debt deduction is disallowed under the hybrid mismatch rules, the debt to which the deduction relates should be excluded from the adjusted average debt calculation. In the absence of such a rule, taxpayers may suffer disallowance of debt deductions in relation to arrangements that have no hybrid element at all, in addition to the deductions denied by the hybrid mismatch rules. We appreciate that a policy intent of the rules may be to encourage restructuring; however, due to the additional uncertainties an integrity rule brings and the existence of arrangements involving third party lenders, many arrangements may not be able to be restructured prior to the rules becoming effective.

3.2 CFC rules

As currently drafted, the ED does not address the interaction of the proposed rules with the CFC rules in Part X of the *Income Tax Assessment Act 1936 (Cth)*.

We submit that introducing the hybrid mismatch rules into the CFC rules would add substantial complexity to any application of Part X. We submit that a modification should be included in Part X to the effect that the hybrid mismatch rules do not apply for the purpose of determining attributable income (similarly to the exclusion of other regimes such as Division 230 and (generally) Division 974).

4 *De minimis* exception

As currently drafted, the ED does not contain any *de minimis* exception (aside from certain exclusions involving deferrals in respect of hybrid financial instruments with a tenor of 3 years or less).

The proposed rules are complex and potentially apply to all taxpayers and transactions. In view of the substantial compliance burden faced by taxpayers in properly assessing and reporting their position under the rules, particularly with respect to the imported mismatch rules which potentially are very far reaching, we submit that a threshold similar to the $2 million threshold applicable under Division 820 (see section 820-35 of the 1997 Act) is appropriate. Such a threshold would not exclude substantial multinationals but would nevertheless serve to substantially relieve the compliance burden for smaller taxpayers.

This type of policy rationale formed the basis for inclusion of the $250,000 threshold in section 820-35 when Division 820 was introduced in 2001, as well as the subsequent increase of that threshold to $2 million. The Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001* noted that *"[t]he compliance burden - particularly on smaller entities operating in Australia - has been significantly eased by the adoption of a de minimis exemption for taxpayers with total debt deductions (combined with those of certain associates) below $250,000 in a financial year. Once a taxpayer establishes that its annual debt deductions do not exceed $250,000, it is outside the thin capitalisation*

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regime and need go no further." Similarly, the Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014* noted that *"[t]o reduce compliance costs and ensure that small businesses are protected from the effects of the thin capitalisation debt tests, the current de minimis threshold will be increased from debt deductions of $250,000 or less, to $2 million or less."*

We submit that a threshold for deductions of $2 million, below which the hybrid mismatch rules would not be activated, would substantially relieve the compliance burden for smaller taxpayers, ensuring they "need go no further" in navigating these complex rules (including the potentially far reaching imported mismatch rules), without excluding substantial multinationals or defeating the overall purpose of the hybrid mismatch rules.

5 Further guidance

We submit that the ED and its Explanatory Memorandum would benefit from the following clarifications:

- **Imported mismatches**: The ED Explanatory Memorandum currently includes examples of hybrid financial instrument mismatches, hybrid payer mismatches, reverse hybrid mismatches and deducting hybrid mismatches. However it does not include any examples of imported hybrid mismatches. We submit that the ED Explanatory Memorandum should be modified to include further guidance on imported mismatches including appropriate examples, to assist taxpayers in understanding and applying these rules.

- **Direct or indirect payments**: The ED refers to payments "*made directly, or indirectly through one or more interposed entities*" in section 832-650 (Hybrid requirement – payment made directly or indirectly to a reverse hybrid) and section 832-795(1) (Meaning of importing payment). Although section 832-795(3) adds some clarity regarding indirect importations, we submit that further guidance is appropriate and the ED (or at least the ED Explanatory Memorandum) should be amended to provide greater clarity on the meaning of this phrase.

- **Foreign exchange (FX) differences**: The ED and Explanatory Memorandum make no reference to the impact of FX differences, which arise very frequently in a cross border context (e.g. financial instruments denominated in a currency that differs from the functional currency of one or both parties to the instruments). We submit that the ED should expressly clarify that the hybrid mismatch rules are not intended to pick up mismatches attributable to differences in the value ascribed to a payment, such as FX gains and losses, in accordance with the principles expressed in paragraphs 12 and 386 of the OECD's final report.

We would welcome the opportunity to discuss these matters further with you. If you have any questions, please do not hesitate to contact Mark Hadassin on 02 9322 5807 or Manu Sriskantharajah on 03 9671 7310.

Yours sincerely

Mark Hadassin
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