Minerals Council of Australia

22 December 2017

The Manager
Base Erosion and Profit Shifting Unit
Corporate Income Tax Division
Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir / Madam

We refer to the Exposure Draft Bill and Explanatory Memorandum implementing the OCED Hybrid Mismatch Rules released for comment on 24 November 2017 and make the following submission on the draft. The time period allowed for consultation is insufficient to comprehensively identify, consider and deal with the issues at hand but we have identified some our key concerns at a high level.

The Minerals Council of Australia (MCA) supports a coordinated international approach to counter emerging Base Erosion and Profit Shifting (BEPS) practices but considers that it is critical that the Australian response adhere as closely as possible to the OECD recommendations. These are of course contained in the final report of the OECD Action 2 issued in 2015[1] (**OECD Report**). Measures that are inconsistent with this report or that go beyond what is recommended for all international jurisdictions may unfairly and unnecessarily disadvantage Australian taxpayers and Australia's mining industry selling mineral commodities in competitive global markets.

The hybrid mismatch rules come in addition to a number of tax integrity and compliance measures over recent years by successive governments. Complex and significant international tax measures require careful consideration to minimise excessive compliance costs which ultimately affect all stakeholders, including governments, and to avoid unnecessarily exposing Australia's tax administration and compliance system to risk.

It is our strongly held view that legislation of this level of complexity and scope of potential implications should not be the subject of limited consultation as has been allowed for in this current process. The consultation process on the exposure draft legislation was complicated due to the fact that interpretation of the proposed rules has not been accompanied by draft administrative guidance from the ATO, which the Board of Taxation recommended be made available to taxpayers at the same time as draft legislation.[2]

The MCA believes that a more fulsome consultation process on the exposure draft would have been appropriate because the draft departs from the recommendations of the OECD in a number of key areas. There are also many new concepts and approaches to tax compliance contained in these measures, the effect of which needs to be carefully considered before being legislated. The provisions need to be discussed and fully understood if we are to achieve an outcome that is workable both from the point of view of the Australian Taxation Office (ATO) and taxpayers alike.

[1] OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[2] Refer paragraph 6.9 of the Board of Taxation's *Implementation of the OECD Hybrid Mismatch Rules* report (March 2016).

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Executive summary

For the reasons set out in the body of this letter, we submit the legislation would benefit from the following changes:

- The date of first application of the proposed hybrid mismatch rules be no earlier than 1 December 2018
- The hybrid mismatch rules should apply to arrangements at the time that they are entered into (or materially altered), rather than requiring fresh consideration at the time of each payment.
- De minimis or grandfathering rules be inserted to reduce compliance costs. A particular focus in this regard should be the application of imported hybrid mismatch rules to pre-existing arrangements. Consistent with the Board of Taxation recommendation this may be accomplished without compromising the integrity of the rules.
- Structured mismatch arrangements – to better reflect the OECD's intended scope of the rules and promote simpler compliance:
  - the testing time for structured mismatch arrangements should be restricted to the time that the arrangement is entered into; and/or
  - the 'financial position' test be amended to capture situations where there is a non-trivial benefit that has been received by the taxpayer from the scheme.

With regard to particular measures, we make more detailed and important comments set out below.

Date of effect and timing of application

The exposure draft legislation is expressed to cover payments made 6 months after the commencement of Division 832 where a relevant hybrid mismatch rule (in subdivisions 832-I to M) is satisfied. The subdivisions identifying the various covered hybrid mismatches, in turn if the payment either gives rise to a mismatch or might be expected to give rise to a mismatch, as the case may be.

Date of effect

We understand that the proposed timetable for the introduction of the hybrid mismatch Bill into Parliament would result in the first application being potentially as early as October 2018, being approximately 10 months from the release of the exposure draft.

MCA observes that in its report, the Board of Taxation encouraged draft legislation to be released 12 months in advance of the proposed commencement date, together with draft ATO administrative guidance to allow taxpayers an opportunity to understand and respond to the complex rules[3]. We consider that the Board's recommendation was appropriate and suggest the rules begin to apply no earlier than December 2018.

Timing of application

The testing of the effects (or expected effects) of arrangement subject to the draft legislation is not confined to the time when the particular arrangement was entered into, but extends to each time that a payment is made. This creates an ongoing compliance burden for taxpayers as well as potential for unfairly punitive application of the hybrid mismatch rules in situations where a mismatch emerges sometime after an arrangement is put in place, such as due to a change in law[4] in one of the jurisdictions concerned.

An Australian example of a law change that may have created a hybrid mismatch was the introduction of Subdivision 768-A to replace Section 23AJ. Subdivision 768-A caused returns on non-share equity instruments[5] from foreign subsidiaries which were previously assessable in Australia to the recipient to become non-assessable non-exempt when received by Australian companies.

It is considered that taxpayers should not be penalised by hybrid mismatch rules when an arrangement that does not result in a hybrid mismatch at inception later begins to produce mismatched outcomes. It

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[3] Refer paragraphs 3.10 and 6.9 of the Board of Taxation's *Implementation of the OECD Hybrid Mismatch Rules* report (March 2016).
[4] or regulation, interpretation, administrative practice, etc.
[5] e.g. legal form debt that is classified as equity under Division 974

is therefore submitted that the hybrid mismatch testing time be restricted to the time (or accounting period) that an arrangement is put in place (with re-testing in the event of a material change to the arrangement).

This approach would be consistent with the broader scheme of Australian income tax legislation which enables taxpayers to determine their tax consequences at the time that a transaction is entered into, in a way that is not contingent on external supervening events.

Imported hybrid mismatches (Subdivision 832-M)

Transition: Of the proposed measures *imported hybrid mismatches* have potentially significant implications for taxpayers particularly for *indirect importations* and; when combined with the open and apparently extensive concept of *structured arrangements*, this provision will have a reach well beyond a company group to transactions that many taxpayers would have expected to be affected by these rules and for which they could suffer adverse tax consequences.

This measure will expose taxpayers to unfavourable tax adjustments, including for pre-existing financial and other arrangements with third parties that are often outside their sphere of control and, in many cases, would not have been entered into for any perceived tax benefit. It is unfair and unnecessarily punitive to impose regulatory changes in these circumstances and this provision in particular should be accompanied with suitable transitional arrangements.

As currently drafted, Subdivision 832-M appears to be capable of applying to taxpayers even when they obtain debt from third party financial institutions if the debt pricing is, to some extent, favourably affected by a hybrid mismatch that exists somewhere in the structure of the third party institution.

During our telephone call of 15 December Treasury personnel highlighted the intention of these rules to change taxpayer behaviour but surely this is not relevant in the case of third party arrangements taken by foreign entities and pre-existing arrangements.

It is submitted that, as a matter of equity, these rules should not apply to pre-existing arrangements that are beyond the control of taxpayers and their ownership groups. From the point of view of reducing red tape and compliance costs for business, it is submitted that the inclusion of a de minimis threshold and/or safe harbour test be considered to help taxpayers obtain certainty in respect of prospective arrangements.

This submission is in line with the recommendations made by the Board of Taxation in its Report[6] which contemplated a degree of grandfathering, de minimis and safe harbour measures in some circumstances, including in relation to third party arrangements and imported mismatch rules (refer Recommendations 3, 4 and 8)

Working out the amount of the imported hybrid mismatch (section 832-805)

This section applies a default tax adjustment approach in determining the amount of an imported hybrid mismatch which takes the lesser of the Australian income tax reduction amount and any remaining offshore hybrid mismatch. However, an Australian imported mismatch payment must be traced through a chain of taxable payments or offsets to see whether the payment has actually been set-off against an "indirect hybrid deduction"[7]. It does not appear that the drafted provisions apply any particular method referred to in paragraph 245 of the OECD Report to establish an appropriate nexus between the imported mismatch payment and the indirect hybrid deduction.

Recognised foreign income taxes (section 832-945)

Following our recent call we understand that Treasury will amend section 832-945(2) to make it clear income or profits will be regarded as not subject to foreign income tax ***"to the extent"*** that the income or profits of an entity attract a foreign tax credit, rebate or other tax concession.

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[6] Board of Taxation, *Implementation of the OECD Hybrid Mismatch Rules* report (March 2016)
[7] Within the meaning of the term as used in the OECD Action 2 2015 Final Report

Structured arrangements (section 832-1010(3)) Scope

Since this aspect of the draft rules extends the reach of hybrid mismatches beyond the control and influence of company groups; it needs to be given full and careful consideration.

The manner in which this sub-section is drafted will make it extremely difficult for an Australian entity to demonstrate that it *was not or could not reasonably be aware of the scheme that gave rise to the mismatch*. This test is difficult to satisfy because awareness of the attributes and effects of the scheme is not confined to the time when the scheme was entered into but also when the scheme *is carried out*.

A taxpayer could become aware of the scheme during the extended time when it is carried out but may be unable to terminate the arrangement or scheme at this time. As stated above, what is actually important is the time when the scheme was entered into. This will often occur in merger and acquisition transactions when finance is required and financing arrangements are entered into. This should be the hybrid mismatch testing time.

Companies and corporate groups are often not be aware of details of extended offshore third party financing arrangements when they are more focussed on the acquisition itself. The benefit of hindsight is that it will always be more clear than when transactions occur and it is inappropriate to hold Australian taxpayers to a more onerous standard when applying the hybrid mismatch provisions.

The OECD Recommendation 10 applies to the definition of structured arrangements and makes a clear reference to arrangements in the past-tense despite the fact these arrangements will have continuing operation when these rules are to be applied. This indicates that it was the intention of the OECD to apply the definition at the time when the arrangements were entered into and there are obvious reasons for this. See also paragraph 342 of the OECD Report that indicates that the correct point of reference is when the arrangement is contemplated and put into effect:

> A person will be a party to a structured arrangement when that person has ***a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be***. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer nor any member of the same control group ***was aware*** of the mismatch in tax outcomes or obtained any benefit from the mismatch. [Emphasis added]

A more balanced and fair way to draft this provision; and one that is aligned with the way most other similar tax provisions are applied; would be to confine the reference time to when the transaction or scheme was entered into and the commitment was made. Once committed to a third party scheme or arrangement, particularly long term financial arrangements, there is often very little room for an Australian entity to unwind or change the arrangement and many Australian mining assets have bought and sold in successive transactions over a number of years. The current owners will not have been aware of the particular circumstances behind inherited structures and arrangements[8] .

As stated above, this aspect of the Australian commercial landscape highlights the critical need for transitional provisions to avoid anomalous and inequitable outcomes when these rules are implemented.

***Benefits from the hybrid mismatch*:**

Draft section 832-1010(3) has been drafted to apply a very onerous negative test which goes beyond the apparent intention of the OECD to limit the scope of affected *structured arrangements*. That is, in Australia you will be taken to be a party to a *structured arrangement* ***unless*** you meet all three of the specified conditions. The legislation, as drafted, will significantly increase compliance burden associated with the hybrid mismatch rules.

Specifically, the test in section 832-1010(3)(c) is difficult to satisfy because it sets a very high threshold of similarity between the entity's actual financial position and a hypothetical financial position. Any difference between the actual scheme that the entity is involved in and a hypothetical scheme which does not give rise to a hybrid mismatch (even if not material, such a slight change to a finance interest rate or not connected to a hybrid feature, such as a different denomination currency) would result in a

[8] Nor did they have an opportunity or cause to conduct due diligence that may have detected such arrangements, prior to the introduction of Hybrid Mismatch rules.

financial position that is not “the same”. Moreover, on current drafting, it would appear that even if the hypothetical non-mismatch scheme resulted in a **better** financial position than the scheme involving the hybrid mismatch, the condition would still be failed.

This aspect of the rules should be amended to better reflect the rules envisaged by the OECD and avoid administratively burdensome and inequitable application of the rules. It is submitted that this is an area that warrants further consideration of the ability to use concepts of materiality or de minimis to limit the potential for anomalous application and excessive compliance costs for taxpayers.

We would welcome a further opportunity to discuss this further with you to assist in the formulation of the final draft. Should you or your staff wish to do so, please contact the MCA’s Director - Taxation, James Sorahan, on (03) 8614 1816.

Yours sincerely

JAMES SORAHAN
DIRECTOR - TAX