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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 – Revised Draft Legislation

Deloitte welcomes the opportunity to comment on the revised exposure draft legislation "*Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2018*" (**Revised ED**) released by the Federal Government on 7 March 2018.

1 Commencement date

We understand from our meeting that the below approach currently is proposed in relation to commencement date. We note that amendments will be required to the Revised ED to reflect this approach.

We understand that:

(a) an application date of 1 January 2019 will be prescribed for Division 832 generally, provided that for Subdivision 832-H (Imported hybrid mismatch), including for purposes of testing offshore hybrid mismatches in the context of the imported mismatch rules, the commencement date would (except in the case of structured imported hybrid mismatch arrangements) be deferred to 1 January 2020;

(b) the application provisions will have regard to the timing of the relevant deduction or inclusion in income rather than timing of the relevant payment; and

(c) the commencement dates for the various new rules in the Revised ED will be aligned (subject to the special transitional rule for regulatory capital in Part 3 of Schedule 2 to the Revised ED) to conform to the above and ensure a consistent approach across Schedules 1 and 2 to the Revised ED (i.e. not limited to Division 832).

We are generally supportive of the above approach although we note that it is predicated on an assumption of timely Bill passage and receipt of Royal Assent by 30 June 2018. The approach of "hard coding" a start date of 1 January 2019 involves a risk, in the event Bill passage and/or Royal Assent is delayed, that the 6 months buffer inherent in the previous commencement proposal (i.e. "6 months after Royal Assent") may be substantially eroded. Accordingly, we submit that the application date should be deferred in the event of significant delays.

2 Targeted integrity rule

We submit that Subdivision 832-J (Integrity rule) goes beyond the scope of the OECD's recommendations by addressing situations that have no element of hybridity. Varying the Australian tax outcomes for Australian borrowers of ordinary debt based on the treatment of lenders under a foreign tax regime involves a fundamental policy change that warrants substantive consideration and consultation in a broader context than is currently the case. Our primary submission is that the integrity rule should not be implemented in its current form but rather should have application only to preserve the effectiveness of the hybrid mismatch measures where there would be a hybrid mismatch but for interposition of the relevant vehicle in the low tax jurisdiction.

If, contrary to the above submission, the integrity rule is retained in the Revised ED in its present form, then we submit that at least the following considerations should be addressed:

(a) The "designed to produce" concept should be replaced with a concept that is settled and well understood for purposes of Australian income tax law, and able to be readily applied in practice without suffering from the challenges identified by various stakeholders in relation to the concept "designed to operate" in section 974-80 of the Income Tax Assessment Act 1997 (see, e.g. Board of Taxation, "*Review of the Debt and Equity Rules – The Related Scheme and Equity Override Integrity Provisions*", December 2014).

(b) In conjunction with the above, the concept of "scheme" should be more precisely articulated so as to clearly encompass the particular facts and circumstances intended to be addressed by the integrity rule and giving rise to the perceived mischief. We understand from our meeting that the principal focus of the provision is intended to be the routing of funds through an interposed foreign entity in a low tax jurisdiction. However, as presently drafted, the integrity rule arguably may be activated where a "scheme" (which on the face of the provision may consist merely of the arrangement, such as a loan agreement, under which the relevant payment is made) has as one of its many intended features (i.e. depending on how broadly the phrase "designed to produce" is interpreted) the availability of an Australian deduction for the payment. Such an outcome goes beyond even the broad effect that we understand is intended for Subdivision 832-J.

(c) The provision should be restructured so that the perceived mischief sought to be addressed is identified as part of the design of the primary tests for application of the provision, rather than left to be addressed via the exceptions. As presently drafted, the primary tests in section 832-800(1) for activation of the integrity rule set a low threshold that would be met by group financing arrangements that are commonplace in practice, thereby placing undue emphasis on the role of the exceptions to exclude arrangements not intended to be within scope.

(d) We note that the key intended focus of the provision (based on our understanding from our meeting), i.e. the routing of funds through an interposed foreign entity in a low tax jurisdiction, does not receive mention in the guidance provision in section 832-795, which seems to focus only on 1 of the 3 exceptions in purporting to outline what the subdivision is about. We submit that the guide needs to be rewritten to clarify the object of the Subdivision and more comprehensively summarise the operative provisions.

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(e) The Revised ED should be amended so as to legislate the design principles sought to be embodied in the examples included in the revised Explanatory Memorandum (**Revised ED EM**). At present those examples, while generally helpful in providing guidance in addition to the Revised ED, imply conclusions as to tax outcomes that are not clearly borne out by the provisions of the Revised ED. Key design principles such as the nature and extent of any substance requirements, the precise level(s) of the structure at which any such requirements are to be tested, the extent to which regard may be had to employees of other group entities in the same country, the circumstances in which the "back to back" arrangements rule in paragraphs (7) and (8) are intended to operate, and the level at which any such enquiries may end without the need to test arrangements "higher" in the structure, also merit substantially more detail than is currently included in the Revised ED.

(f) The concept of "residency" and "residence" in subparagraphs 832-800(1)(d) and (g), respectively, should be defined to clarify the position with respect to territorial jurisdictions (e.g. Hong Kong) or jurisdictions that impose tax on worldwide income on a basis other than residence (e.g. the US), as well as with respect to entities other than companies (e.g. limited partnerships). As currently drafted it is not clear whether Australian or foreign law concepts of "residence" are intended to be applied in resolving these and other matters. The lack of clear guidance in these parts of the integrity rule may be contrasted with section 832-595(8) which relates to residency for deducting hybrids, and section 830-10(1)(c) of the Income Tax Assessment Act 1997 which relates to residency for foreign hybrid limited partnerships.

(g) The requirement for a minimum tax rate in paragraph 832-800(1)(g) requires that the relevant payment is subject to tax "in the country of residence of the interposed foreign entity". This is likely to be problematic where a partnership or trust is the interposed foreign entity and the partners or beneficiaries of the trust are tax resident in a different jurisdiction. It might well be the case that the partners or beneficiaries could be subject to tax at a greater than 10% rate but in a different country to the partnership or trustee. In contrast, the deduction / non-inclusion rule in section 832-100 does not require that the foreign tax be payable in a particular country and we submit that a similar approach should be adopted in this provision.

(h) The rationale for the specific references in section 832-800(2)(a) to sections 456 and 457, in contrast with references in similar provisions elsewhere in the Revised ED to "Part X", is not immediately apparent. Moreover, the concept of a "corresponding provision" should be clarified to cover comprehensive foreign CFC regimes as a whole. The concept of "accruals tax law" in regulation 18 of the Income Tax Assessment (1936 Act) Regulation 2015 may be useful in this regard. As noted in our meeting we submit that the US "GILTI" inclusion should be recognised as a corresponding provision for this purpose provided, of course, that the relevant interest income is in fact within the GILTI tax base (with such recognition made clear in the Revised ED, the Revised ED EM, or ATO guidance). We would welcome the opportunity to discuss this specific issue with you further.

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 7251 or Manu Sriskantharajah on 03 9671 7310.

Yours sincerely

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