LCR 2019/D1EC - Compendium

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Public advice and guidance compendium – LCR 2019/D1 (as published 5 April 2019)

Relying on this Compendium

This Compendium of comments provides responses to comments received to 8 July 2020 on draft Law Companion Ruling LCR 2019/D1 *OECD hybrid mismatch rules – targeted integrity rule*. It is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this Compendium does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

An updated version of this compendium will be published when draft Law Companion Ruling LCR 2019/D1 (incorporating comments received on the version published on 8 July 2020) is finalised.

Summary of issues raised and responses

Issue No.	Issue raised	ATO response
1	The draft Ruling does not address the situation where the relevant payment is subject to tax in a foreign country that has a headline rate of greater than 10%, but deductions (including items that would hypothetically be allowable if incurred by an Australian taxpayer) reduce the effective foreign tax paid on the payment to 10% or less.	Paragraph 51 of the revised draft Ruling has been amended to provide further clarification on this issue.
2	Where the recipient of the payment or ultimate parent entity (UPE) is a tax-transparent entity, then a range of tax rates may apply to the payment depending on the circumstances of members. The integrity rule should not apply to the extent that members of the recipient entity pay tax on their share of the payment at a rate of greater than 10%. The integrity rule should also not apply to the extent the payment would have been subject to a rate of 10% or less in the hand of members of the UPE.	Paragraph 11 of the revised draft Ruling outlines that where the conditions (in subsection 832-725(1))[1] for applying the targeted integrity rule are satisfied, subsection 832-725(3) applies to deny the entity's entitlement to a deduction for the whole of the payment. If the facts lead to the application of the rule, the deduction is denied to the entity in accordance with subsection 832-725(3) in its entirety – there is no 'to the extent' qualification in subsection 832-725(3). The facts and circumstances of the UPE may be relevant in the consideration of whether the 'requisite purpose' exists. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances.

[1] All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

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3	In a scenario where the interposed entity and UPE are resident in the same country or resident in a jurisdiction which only subjects a payment to income tax if remitted to the relevant country, if the payment was made to the UPE, the payment would not be subject to foreign income tax on the assumption the circumstances in relation to remittance of the payment should by extension be the same for the UPE (that is, foreign parent would also not remit the payment). We recommend the Commissioner include some comments to this effect or an example in the final Ruling to confirm this view.	Rulings cannot address all possible circumstances and there is a need to balance coverage with likelihood. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances. The facts and circumstances of the interposed foreign entity and the UPE may be relevant in the consideration of whether the requisite purpose exists.
4	**Principal purpose test** The discussion in relation to the principal purpose test is overly simplistic and should address other elements of the test. For example: • In each example, what is the scheme? • The vibe of the draft Ruling is that the funding of the lender is the critical element of the test. It should be made clear that this is not the statutory test and a fully equity-funded low-tax lender may not have the requisite purpose, taking I into account the stipulated factors in subsection 832-725(2). It would be useful to have an example to illustrate this point. • Where the loan is funded from retained earnings of an active financing business, that is not traceable to an equity injection but the low-tax lender has substantial equity capital. • Where the loan is funded from an equity injection but the other stipulated factors lead to the overall conclusion that the requisite purpose does not exist.	Rulings cannot address all possible circumstances and there is a need to balance coverage with likelihood. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances. Paragraph 60 of the revised draft Ruling stipulates that paragraphs 11 to 16 of Law Companion Ruling LCR 2015/2 *Section 177DA of the Income Tax Assessment Act* 1936*: schemes that limit a taxable presence in Australia* will be relevant for the Commissioner's interpretation of the principal purpose test.
5	**Principal purpose test** We recommend the Commissioner include an example in the final Ruling how matter (b) in relation to the principal purpose test may be applied to an entity which otherwise carries on substantial financial business activities and/or has multiple sources of	Rulings cannot address all possible circumstances and there is a need to balance coverage with likelihood. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances.

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	funding, but finances a particular loan to an Australian entity via equity injection.	Paragraph 60 of the revised draft Ruling stipulates that paragraphs 11 to 16 of LCR 2015/2 will be relevant for the Commissioner's interpretation of the principal purpose test. In addition, paragraph 89 of the revised draft Ruling specifies that a specific source of funding would indicate that the matter in paragraph 832-725(2)(b) should hold greater significance or weight in determining the principal purpose test than the matters in paragraph 832-725(2)(c).
6	**Equity funding** The draft Ruling examples equate substantial commercial activities for an interposed entity carrying on a banking, financial or similar business with how funds are sourced by that entity. That is, if funding is sourced through equity, this suggests that the entity does not engage in substantial commercial activities in carrying on a banking, financial or other similar business. This is punitive to entities that don't have diverse sources of funding but otherwise carry on substantial commercial financial business activities. This aspect of the draft Ruling appears to be geared towards the banking sector. The final Ruling could provide more balanced guidance for taxpayers in a variety of industries and circumstances.	Paragraphs 70 and 72 of the revised draft Ruling explain why equity funding is more likely to result in a deduction/non inclusion outcome being replicated through the arrangement.
7	Little or no guidance is available as to what a 'financial business' or 'other similar business' constitutes. As such, the Commissioner should consider including further comments in the final Ruling in relation to the meaning of the terms 'financial and other similar business' to be more relevant for a larger population of taxpayers. At the moment, there appears to be a strong focus on entities engaging in a banking business without further reference to financial or similar business activities.	Paragraph 75 of the revised draft Ruling sets out factors indicative of a financial business. This is not an exhaustive list of factors but sets out the more common attributes of a 'financial business' or 'other similar business'. Paragraph 77 has also been added to the revised draft Ruling to assist understanding.
8	It would help to have it confirmed that a situation where interest is taxed at more than 10% is not susceptible to Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) because, in our view, that is consistent with the clear intention of the Commonwealth Parliament (refer to paragraphs 1.23 and 1.352 of	We do not agree with this view. Where the targeted integrity rule does not apply in a particular case, this will not preclude consideration of the application of Part IVA of ITAA 1936 (depending on all of the relevant facts and circumstances).

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	the Revised Explanatory Memorandum to the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018). This could be the case regardless of whether we are considering a new loan or restructuring out of an existing loan.	Paragraph 15 has been added to the revised draft Ruling to confirm the Commissioner's view on this issue.
9	**Cash pooling** The draft Ruling doesn't currently provide guidance where substantial funding is sourced internally from other members of the Division 832 control group – in particular, cash pooling established to manage the group's internal funding needs. The fact the cash pool header in these arrangements doesn't borrow externally to fund its lending activities should not be a negative indicator when determining whether the principal purpose test is met. If the entity is in fact borrowing, rather than funding its advances to other entities via equity, and the debt is on arm's length terms, the commercial decision to borrow internally (which is generally less costly, simpler and provides more flexibility) should not be viewed materially differently than borrowing externally when considering the application of the principal purpose test. Given cash pools and other internal borrowings are used by many taxpayers, we recommend an example or some guidance is included in the final Ruling in relation to how the principal purpose test may apply to these entities. In addition to the above, we recommend the Commissioner acknowledge that the principal purpose test may not be satisfied where the interposed foreign entity borrows internally (rather than internally and externally) to fund its lending to other group members (whether this is under a cash pool arrangement or intra-group borrowing more generally). **Internally-generated earnings** Further clarification is sought from the Commissioner on how the principal purpose test may apply to an entity that was initially funded by equity but has since provided loans to group entities in a number of jurisdictions allowing the entity to advance further funds from the earnings generated from its loan book. In this	The method of funding for the interposed entity is not considered in isolation and such a matter is to be considered with the other matters, set out in subsection 832-725(2), to determine whether the purpose test is or is not satisfied. Paragraph 61 of the revised draft Ruling notes that regard must be had to all of the matters in subsection 832-725(2). Paragraphs 70 and 71 of the revised draft Ruling set out some circumstances to indicate the relative risk (for the matter set out in paragraph 832-725(2)(b)) related to the source of funds used to provide the loan. Rulings cannot address all possible circumstances and there is a need to balance coverage with likelihood. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances.

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	regard, arguably, there is a pool of funds comprising equity and earnings from which loans are provided by the lending entity.	
10	**Back-to-back loans** The Commissioner's views should be more substantially and clearly explained. In particular: • Regarding the example in paragraph 67 of the draft Ruling, broadly, further explanation is required regarding whether loans are considered to have been structured with the purpose or effect of a back-to-back arrangement. • The reference to 'tracing and nexus' at paragraph 68 of the draft Ruling warrants expansion to address what is the basis for it and what are the applicable principles for applying it. • The draft Ruling does not address the precise manner in which the targeted integrity rule tests are to be applied once the statutory assumption is made that the relevant payment is treated as having been made to an 'ultimate payee' (being the final recipient of the relevant payment under a back-to-back loan).	Paragraphs 96 and 97 have been amended in the revised draft Ruling to provide further clarification on this issue. Paragraph 101 of the revised draft Ruling clarifies that where the conditions in subsection 832-730(1) are met, the integrity rule is applied on the basis that the original paying entity made the payment to the foreign entity and paragraph 102 of the revised draft Ruling confirms that this provides the relevant tax outcomes (for the integrity rule).
11	**Further examples** Further examples should be provided in the final Ruling where the application of the principal purpose test is more nuanced. The examples need not state the conclusive ATO view but could include comment on the factors the ATO would give greater weight to in the given circumstances.	Rulings cannot address all possible circumstances and there is a need to balance coverage with likelihood. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances. Paragraph 60 of the revised draft Ruling stipulates that paragraphs 11 to 16 of LCR 2015/2 will be relevant for the Commissioner's interpretation of the principal purpose test.
12	**Expectation of a payment** This issue relates to an entity having a structure in place, making losses in the first few years and starting to pay up dividends when they are making profits in later years. The company had the intention of returning the income from the start. The intention of the structure was not to avoid tax.	The matter raised is outside the scope of the Ruling. Taxpayers who find themselves in this scenario are encouraged to approach the Commissioner for advice on their specific circumstances.

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13	If a payment is remitted in a subsequent period (the accrual deduction having been denied in Australia under Subdivision 832-J), does the interest deduction become available when incurred (amended assessment), when taxed offshore or not at all?	There is no provision that reinstates a deduction that has been denied under the targeted integrity rule. The facts and circumstances related to remittance of the payment may be relevant in consideration of whether the requisite purpose exists. We invite taxpayers to engage with us to discuss their questions and ascertain what products may be available in their circumstances.
14	It would be helpful to know how the ATO plans to interpret 'law of a foreign country that has substantially the same effect as Part C' in relation to the United States of America (subpart F of the United States *Internal Revenue Code of 1986*, including global intangible low taxed income), United Kingdom and countries that plan to adopt European Union *Anti-Tax Avoidance Directive* controlled foreign company rules.	The matter raised is outside the scope of the Ruling. For further information about the ATO's view of whether section 951A of the United States *Internal Revenue Code of 1986* is a provision of a law of a foreign country that corresponds to section 456 or 457 of the ITAA 1936 for the purpose of subsection 832-130(5), refer to Draft Taxation Determination TD 2019/D12 *Income tax: is section 951A of the US Internal Revenue Code a provision of a law of a foreign country that corresponds to section 456 or 457 of the Income Tax Assessment Act 1936 for the purpose of subsection 832-130(5) of the Income Tax Assessment Act 1997?*