LCR 2019/D1 - OECD hybrid mismatch rules - targeted integrity rule

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OECD hybrid mismatch rules – targeted integrity rule

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Table of Contents **Paragraph**

What this draft Ruling is about

1. This draft Ruling[1] provides the Commissioner's view of particular aspects of the law in relation to the hybrid mismatch targeted integrity rule in Subdivision 832-J of the *Income Tax Assessment Act 1997*[2], legislated as part of the package of measures making up Australia's hybrid mismatch rules including Division 832.

Date of effect

2. It is proposed that this draft Ruling will be finalised as a public ruling, effective from 1 January 2019.

Outline of the law

3. The hybrid mismatch rules are intended to deter the use of certain hybrid arrangements that exploit differences in the tax treatment of an arrangement and/or entity under the income tax laws of two or more countries. When applicable they neutralise the effect of hybrid mismatches so that unfair tax advantages do not accrue for multinational groups as compared with domestic groups.

4. The hybrid mismatch rules, including the targeted integrity rule, apply to pre-existing arrangements in the same way as they apply to arrangements entered into after the application date of Division 832.

5. For the purposes of these rules a hybrid mismatch arises where there is a double non-taxation benefit where a cross border dealing results in:

- a deduction/non-inclusion (D/NI) mismatch (broadly, a deduction being received for a payment in one country, where the corresponding income is not assessable income in another country), or
- a deduction/deduction (DD) mismatch (broadly, a deduction entitlement arising in two countries for the same payment).

[1] All further references to 'this Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.
[2] All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

6. In addition the hybrid mismatch rules include the targeted integrity rule at Subdivision 832-J, which seeks to prevent offshore multinationals from otherwise circumventing the hybrid mismatch rules by routing investment or financing into Australia via an entity located in a no or low tax (10% or less) jurisdiction. Were it not for the targeted integrity rule, the interposition of such an entity would otherwise effectively replicate a D/NI mismatch[3] but fall outside the scope of the operative provisions of Division 832 pertaining to a D/NI mismatch.[4]

7. Under Subdivision 832-J, where the core elements are present, the targeted integrity rule will apply to deny the deduction for a payment of interest[5] or an amount under a derivative financial arrangement.[6] The core elements, each of which have to be present for the rule to apply, are outlined in subsection 832-725(1) as follows:

- an entity (the paying entity) makes a payment to a foreign entity (the interposed foreign entity), either directly or indirectly[7]
- the paying entity, the interposed foreign entity and another foreign entity (the ultimate parent entity) are all in the same Division 832 control group[8]
- the ultimate parent entity is not controlled by any other entity (other than an entity that is not a member of the Division 832 control group)
- disregarding section 832-725, the paying entity would otherwise be entitled to a deduction in an income year in respect of the payment
- the payment is not subject to Australian income tax
- the payment is either
  - subject to a foreign income tax in one or more foreign countries with the highest rate of tax not exceeding 10%, or
  - not subject to foreign income tax, and
- it is reasonable to conclude (having regard to the matters referred to in paragraph 8 of this Ruling) that the entity, or one of the entities that entered into or carried out any part of the scheme, did so for a principal purpose of, or for more than one principal purpose that includes a purpose of
  - enabling a deduction to be obtained in respect of the payment, and
  - enabling foreign income tax to not be imposed on the payment or to be imposed at a rate not exceeding 10%.

8. The principal purpose test[9] is to be determined having regard to matters outlined in subsection 832-725(2) as follows:

- the facts and circumstances that exist in relation to the scheme
- if the payment is an amount of interest, the source of funds used by the interposed foreign entity to provide the paying entity with the loan or debt on which the interest payment is made, and

[3] Refer paragraph 1.351 of the Revised Explanatory Memorandum to the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 (EM).
[4] Operative provisions of Division 832 pertaining to a D/NI mismatch – that is, Subdivision 832-C (Hybrid financial instrument mismatch), Subdivision 832-D (Hybrid payer mismatch), Subdivision 832-E (Reverse hybrid mismatch).
[5] Within the meaning of subsection 128A(1AB) of the *Income Tax Assessment Act 1936* (ITAA 1936) per paragraph 832-725(1)(d).
[6] Derivative financial arrangement has the meaning given by subsection 230-350(1).
[7] That is, through one or more interposed Australian trusts or partnerships within the meaning of Part X of the ITAA 1936.
[8] Refer section 832-205.
[9] Paragraph 832-725(1)(h).

- whether the interposed foreign entity engages in substantial commercial activities in carrying on a banking, financial or other similar business.

9. Where the conditions (in subsection 832-725(1)) for applying the targeted integrity rule are satisfied, subsection 832-725(3) applies to deny the paying entity's entitlement to a deduction for the whole of the payment.

10. There are certain exceptions[10] to the operation of the targeted integrity rule. A deduction for the payment will not be denied under the rule if, in any of the following contexts, it is reasonable to conclude that:

- the payment is taken into account under Part X of the ITAA 1936 and the sum of the attribution percentages of each attributable taxpayer in relation to the interposed foreign entity[11] is at least 100%, or
- the payment is taken into account under a law of a foreign country that has substantially the same effect as Part X and the sum of the foreign equivalent of attribution percentages of each attributable taxpayer in relation to the interposed foreign entity is at least 100%, or
- assuming that the payment was treated as being divided into two separate payments, the payments are taken into account under Part X (or a law of a foreign country that has substantially the same effect as Part X) and the sum of the attribution percentages of each attributable taxpayer in relation to the interposed foreign entity (and/or the foreign equivalent thereof) is at least 100%, or
- assuming that the payment had instead been made directly from the paying entity to the ultimate parent entity of the Division 832 control group
  - the payment would not have been subject to foreign income tax or if it was it would have been subject to foreign income tax at a rate that is the same or less than the highest rate of foreign income tax that did apply to the payment, and
  - the assumed payment would not otherwise have triggered the operative provisions of Division 832 pertaining to a D/NI mismatch.

11. The targeted integrity rule also applies to payments made under a back-to-back arrangement pursuant to section 832-730 where one or more entities are interposed between the original paying entity and the foreign entity. In a back-to-back arrangement Subdivision 832-J is to apply as if the original paying entity had made the payment to the foreign entity.

12. Consistent with the approach throughout Division 832, in the event that Subdivision 832-J applies and a deduction is denied, the character of the payment is not affected for any other Australian income tax purposes (for example, the withholding tax provisions in Division 11A of Part III of the ITAA 1936 and the thin capitalisation rules in Division 820).

[10] Refer subsections 832-725(4) and (5).
[11] For the purposes of sections 456 and 457 of the ITAA 1936 in respect of the income year in which the payment is made.

Specific issues for guidance

Control of the ultimate parent entity

13. The targeted integrity rule only applies to multinational groups and requires the identification of at least three separate entities that are members of the same Division 832 control group:

- the paying entity – that is, the party who (but for the potential operation of this rule) would otherwise be entitled to a deduction for the payment for Australian income tax purposes
- a foreign entity (that is, the interposed foreign entity) in receipt of the payment, and
- another foreign entity that is the ultimate parent entity of the Division 832 control group (in respect of which it, the paying entity and the interposed foreign entity are members).

14. Broadly, two (or more) entities are in the same Division 832 control group if[12]:

- the entities are consolidated with one another for accounting purposes in the same group, or
- one of the entities holds a total participation interest of 50% or more in the other entity (or each of the other entities), or
- a third entity holds a total participation interest of 50% or more in each of the (subsidiary) entities.

15. Paragraph 832-725(1)(c) identifies the ultimate parent entity[13] of a Division 832 control group as a foreign entity which is **not** controlled by any other entity, other than an entity that is **not** a member of the Division 832 control group. Another way of expressing this requirement would be that an entity is the ultimate parent entity provided no other member of the Division 832 control group controls that entity.

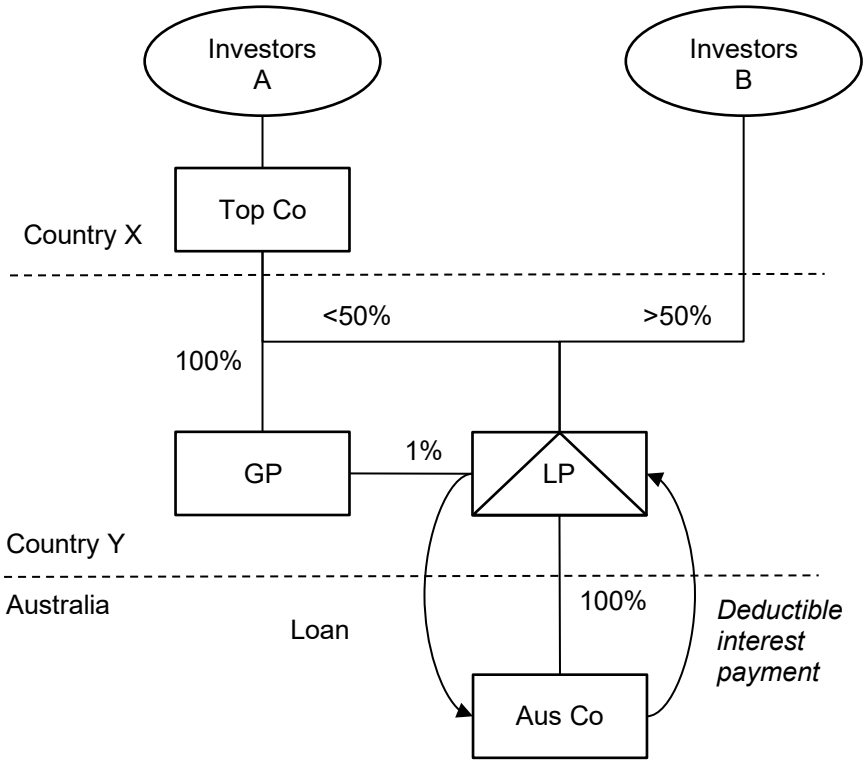
16. The ultimate parent entity of the Division 832 group will typically be the ultimate majority owner of participation interests. However, in circumstances where entities have been grouped with one another for accounting consolidation purposes on the basis of accounting control, it may be the case that entities are members of the same Division 832 control group where one entity does not have total participation interests of 50% or more in the other.

17. A paying entity can be a member of more than one Divisions 832 control group and as a result can potentially have more than one ultimate parent entity for the purposes of the targeted integrity rule.

18. The Commissioner's view of the meaning of the word 'controlled' as used in paragraph 832-725(1)(c) is that it is intended to reflect the conditions that cause the entities to be members of the Division 832 control group. Accordingly, if the reason why the entities are members of the same Division 832 control group is because they have been grouped for accounting consolidation purposes, that same control criterion should be relevant to identifying the ultimate parent entity of that control group for the purposes of the targeted integrity rule. Conversely, if the entities are in the same Division 832 control group as a result of participation interests one might have in the other, the participation interest control criterion should be relevant to identifying the ultimate parent entity of that control group.

[12] Section 832-205.
[13] For the purposes of the targeted integrity rule (and, in particular, the condition in paragraph 832-725(1)(b)).

Example 1 – Control and identification of ultimate parent entity



Background facts

19. *A foreign entity, Top Co, is widely held by unrelated foreign resident investors (Investors A).*

20. *Top Co holds less than 50% of total participation interests in a limited partnership (LP). The remaining percentage of LP is widely held by unrelated foreign investors (Investors B).*

21. *Top Co also holds 100% of the total participation interests in a foreign resident company (GP) which acts as the general partner of LP. GP has 'operational control' of LP for accounting purposes.*

22. *LP holds 100% of the total participation interests in an Australian resident company, Aus Co.*

23. *Top Co, GP, LP and Aus Co are consolidated in the same group for accounting purposes.*

Analysis

24. *Top Co, GP , LP and Aus Co will be members of the same Division 832 control group pursuant to paragraph 832-205(1)(a).*

25. *Top Co is a member of the Division 832 control group and is not controlled by any other entity in the Division 832 control group. Top Co is therefore the ultimate parent entity for the purpose of paragraph 832-725(1)(c). This is despite Top Co not having total participation interests of 50% or more in LP or Aus Co and with an entitlement to less than 50% of the economic gains in LP.*

26. *LP is not the ultimate parent entity of the Division 832 control group because it is controlled by GP*[14] *for accounting consolidation purposes and, in this case, the accounting consolidation criterion is what defines the membership of the Division 832 control group.*

Subject to foreign tax at a rate of 10% or less

27. The targeted integrity rule only applies to the payment of interest, or an amount under a derivative financial arrangement, which is not subject to foreign income tax, or the highest rate of foreign income tax applied to the payment is 10% or less.[15] Where two countries both tax the whole payment, it is the higher rate of tax that is applied to the whole of the payment that is determinative rather than ascertaining a cumulative effect for these purposes.

28. Unlike the other Subdivisions in Division 832 the targeted integrity rule does not measure the 'amount' of a D/NI[16] and the 'subject to foreign income tax' test is a gateway test for the rule rather than being determinative of the amount denied. In the Commissioner's view, the targeted integrity rule requires the whole of the payment to be subject to foreign income tax at a rate of greater than 10%, in order to fall outside the condition in subsection 832-725(1)(g). (Alternatively, the rule will not apply if the payment is subject to Australian income tax.[17])

29. Broadly, an amount of income or profits is subject to foreign income tax if foreign income tax[18] is payable under the law of the foreign country because the amount is included in that country's tax base.[19]

30. Paragraph 1.103 of the EM states that amounts would not be regarded as subject to foreign income tax if a foreign law does not impose tax on the type of payment or subjects the type of payment to tax at a rate of 0%. Similarly, where a payment is made to an entity in a country that does not impose an income tax, the payment cannot be regarded as having been subject to income tax in that country.

31. Where a payment is subject to foreign income tax within the meaning of section 832-130, the question of whether the rate of tax applied to the whole of the payment is 10% or less must be answered having regard to the specific facts surrounding the actual payment. Regardless of whether a country has a headline corporate rate of more than 10%, if tax imposed on the actual interest or derivative payment is at a rate equal to or less than 10% the payment would nevertheless be in the scope of the targeted integrity rule (subject to the other qualifying factors also being satisfied).

32. Furthermore, a payment which is only subject to foreign income tax if remitted to the foreign country will only be regarded as being subject to foreign tax at a particular rate if it is in fact remitted. As the payments are between entities within a Division 832 control group, the payer should be aware of, or be able to confirm, the treatment of the payment under the foreign laws of the payee's country.

33. If an entity has negotiated a tax holiday or concessional rate of tax on the basis of its particular activities or status, this would also impact on whether an amount of tax is payable and would therefore be relevant in determining the rate of foreign tax applicable for the purposes of the targeted integrity rule.

[14] Another entity of the Division 832 control group.
[15] Paragraph 832-725(1)(g).
[16] Section 832-105.
[17] Paragraph 832-725(1)(f).
[18] With the exception of credit absorption tax (as defined in subsection 770-15(2)), unitary tax (as defined in subsection 770-15(3)) or withholding-type tax.
[19] Section 832-130.

Principal purpose test – paragraph 832-725(1)(h)

34. As noted at paragraph 7 of this Ruling, in order for the targeted integrity rule to apply, one of the key prerequisites is that it must be reasonable to conclude that the entity, or one of the entities who entered into or carried out any part of the scheme, did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:

- enabling a deduction to be obtained in respect of the payment, and
- enabling foreign income tax to be imposed on the payment at a rate of 10% or less, or enabling foreign income tax not to be imposed on the payment.

35. The phrase '…for the purpose of, or for more than one principal purpose that includes a purpose of…' is also used in the context of the multinational anti-avoidance legislation (MAAL)[20] and the diverted profits tax (DPT).[21] Although the MAAL and DPT are in Part IVA of the ITAA 1936 and the hybrid rules are not, the meaning of the phrase will be interpreted consistently by the Commissioner for the purposes of paragraph 832-725(1)(h). The Commissioner's view is that it is therefore appropriate to interpret the phrase in the targeted integrity rule consistent with the views contained in 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*.

Matters in subsection 832-725(2)

36. As set out in paragraph 8 of this Ruling, for the purposes of determining the reasonableness of the conclusion arrived at in the context of the principal purpose test in section 832-725(1)(h), have regard to the matters outlined in subsection 832-725(2).

The facts and circumstances that exist in relation to the scheme (matter (a))

37. The targeted integrity rule is intended to ensure that the effect of the hybrid mismatch rules to counter the exploitation of different tax treatments in different tax jurisdictions cannot be circumvented by the adoption of particular investment structures.[22] It is directed at structures with the potential to effectively replicate a D/NI outcome where multinational groups may interpose conduit-type entities effectively paying no tax to invest into Australia.[23]

38. The circumstances surrounding the establishment of the interposed entity and how it fits into the overall structure of the Division 832 control group would be relevant in considering whether the paying entity or one of the entities who entered into or carried out the scheme (or any part of the scheme) did so for the requisite purpose.

39. The facts and circumstances to be considered under the first matter in paragraph 832-725(2)(a) have been drafted with a broad scope beyond those facts and circumstances that relate directly to the interposed foreign entity that receives the payment which gives rise to the deduction. The relevant scheme referred to in this matter would include not only the payment arrangement but all of the surrounding facts and circumstances[24] including the indirect funding of the interposed entity. The concept of scheme is broad enough to encompass any actions or arrangements entered into by any of the parties to the scheme also contributing to the effective replication of the D/NI outcome, the subject of Subdivision 832-J.

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[20] Paragraph 177DA(1)(b) of the ITAA 1936.
[21] Paragraph 177J(1)(b) of the ITAA 1936.
[22] Department of Treasury, 2017, *Mid-Year Economic and Fiscal Outlook 2017-18*, Commonwealth of Australia, Canberra, p. 120.
[23] Paragraph 1.351 of the EM.
[24] Giving rise to the enablement of the deduction and the enablement of the imposition of foreign income tax at a rate of 10% or less (or foreign income tax not to be imposed on the payment).

40. In the Commissioner's view, participation interests held by entities outside the Division 832 control group or circumstances surrounding the functions and activities carried out by the interposed entity would also be relevant matters to be taken into account under paragraph 832-725(2)(a). However, whether such facts and circumstances are indicative of the requisite principal purpose can only be tested by an examination and weighing up of the actual facts and circumstances of an individual scheme.

Example 2 – matter (a)

Background facts

41. *Following on from Example 1, Aus Co is determining whether the targeted integrity rule applies with respect to the interest payment to LP. Assume that the gateway requirements of the targeted integrity rule in paragraphs 832-725(1)(a) to (g) are met.*

Analysis

42. *That greater than 50%[25] of LP is owned by investors outside of the Division 832 control group is a relevant fact as part of the scheme that should be taken into account in determining whether the principal purpose test in 832-725(1)(h) is satisfied. For example, the extent to which ownership interests held by non-Division 832 control group members dilute the benefit to the ultimate parent entity of the effective replication of a D/NI outcome would be a relevant consideration.*

43. *In practice, these facts would need to be weighed up against other facts and circumstances of the scheme and including the matters specified in paragraphs 832-725(2)(b) and (c) in determining whether paragraph 832-725(1)(h) is met.*

The source of the funds used by the interposed foreign entity (the payee) to provide the entity (the payer) with the debt interest (in respect of which the interest payment is made) (matter (b))

44. In the case of interest payments, the source of the funds used by the interposed entity to provide the loan or debt interest is a specific matter to which regard must be had in applying the principal purpose test. In the Commissioner's view, this matter looks to the source of funds from the perspective of the interposed entity and involves an enquiry into the character of that flow, servicing costs associated with that source, and the foreign tax effects to the interposed entity and the broader Division 832 control group of the interposed entity sourcing funds in that manner and of that particular character compared with alternative sources and characterisations.

45. This view is supported by the outcomes focus underlying the objective of the targeted integrity rule, which is to deny the deduction from arrangements which effectively replicate D/NI outcomes.[26] The effective replication of a D/NI outcome is maximised where, from the perspective of the interposed foreign entity, the funding is sourced in such a way as to not bear a servicing cost (for example by way of equity) and not be subject to tax at the ultimate parent entity's income tax rate (for example because it enjoys some sort of participation exemption and little if any controlled foreign company attribution).[27]

46. Conversely, to the extent the funding for the interposed entity is sourced, for example, by way of interest-bearing debt (and it is reasonable to expect the interest in the hands of the lender would be subject to foreign tax at a rate in excess of 10%), then the potential D/NI replication effect (from the perspective of the ultimate parent entity) of

[25] This percentage is illustrative only and should not be taken as a bright line test.
[26] Paragraph 1.351 of the EM.
[27] Refer Example 1.26 of the EM.

interposing the foreign entity would be mitigated. As noted in the EM at paragraph 1.356 the principal purpose test would be expected to be satisfied where the ultimate parent entity routes funding through a no (or low) tax jurisdiction as a conduit to effectively convert taxable interest income to exempt dividends. It would be less likely that the principal purpose test would be satisfied, were it to source the funds from borrowings from third parties unrelated to any members of the Division 832 control group. Source in this context does not specifically refer to the identity or location of the investor, though these factors may also be relevant to determining the foreign tax effects to the interposed foreign entity and the broader Division 832 control group of sourcing the funds in that manner and of that character. Essentially, where the payment is an amount of interest, the second matter requires one to consider whether effectively there can be a conversion of a taxable interest payment in the ultimate recipient's hands to a non-taxable[28] return as a result of being routed via the interposed foreign entity.

Whether the interposed foreign entity (the payee) engages in substantial commercial activities in carrying on a banking, financial or other similar business (matter (c))

47. This matter requires one to consider the degree and nature of the economic activity undertaken by the payee. Whether there are substantial commercial activities being carried out by the interposed foreign entity will depend on the relevant facts and circumstances including an analysis of the entity's particular functions, assets and risks. Whilst there may be scope for the activities to be staffed by people not directly employed by the interposed foreign entity (for example, a related or sister entity), it must nevertheless be the interposed foreign entity that is conducting the substantial commercial activities in terms that we would be familiar with in the context of functions, assets and risks.

48. Whether the activities in question conducted by the interposed foreign entity are sufficiently analogous to the carrying on of a banking, financial, or other similar business essentially is a factual enquiry, having regard again to the functions, assets and risks of that entity. The relevance of this matter is that to the extent it can be satisfied, it is a pointer economically to the business in question being one of the nature of borrowing and lending such that any effective replication of the D/NI mismatch (similar to the second factor in paragraph 46 in this Ruling relating to source) would be mitigated or at least limited to the margin.

49. Factors pointing to such a characterisation of the business being carried on by the interposed foreign entity would include:

- undertaking spread activities common to banking business[29]
- actual borrowing and lending, and the identity of the lenders and borrowers
- a pooling of funds approach (typically a feature in the banking and finance industry) that would make it difficult to ascertain the source of funds (pointed to in matter (b) in paragraph 44 of this Ruling)
- risk management activities consistent with such a business, and
- whether the interposed foreign entity is capitalised in a manner and at a level consistent with that of a stand-alone entity engaged in such business.

50. A 'shell' company with few functions, assets or risks of its own in relation to its lending or derivative arrangements would not be considered to engage in substantial commercial activities in carrying on a banking, financial or other similar business.

[28] Non-taxable for the purposes of Subdivision 832J includes tax rates of 10% or less.

[29] For example, refer to description of spread activities in Taxation Ruling TR 2005/5 *Income tax: ascertaining the right to tax United States (US) and United Kingdom (UK) resident financial institutions under the US and the UK Taxation Conventions in respect of interest income arising in Australia*.

51. Conversely substantial commercial activities are more relevant in the context of the principal purpose test to the extent those activities constitute carrying on a banking, financial or other similar business. Substantial commercial activities of any other nature are not elevated for particular regard for the purposes of paragraph 832-725(1)(h).

Example 3 – matter (c)

Background facts

52. *Parent Co wholly owns all of the shares in its Australian subsidiary, Aus Co, and a company incorporated in Country Y, Interposed Co.*

53. *Interposed Co performs an internal treasury function for the group and makes interest bearing loans to group subsidiaries including Aus Co. Interposed Co does not make loans to entities outside the Parent Co multinational group.*

54. *Interposed Co has employees whose roles include activities relating to the management of the loan receivables owing to it from group members.*

55. *Interposed Co has no borrowings. The loans it makes to group subsidiaries, including Aus Co, are funded from separate equity capital injections from Parent Co.*

Analysis

56. *A banking or financial business would typically involve raising finance through borrowing and on-lending at a margin. The fact that the Interposed Co does not borrow and on-lend, but rather sources its funding through equity capital injections, suggests that Interposed Co does not engage in substantial commercial activities in carrying on a banking, financial or other similar business. Whilst there may be employees whose role involves managing the loan book, given the lending is intra-group, that task is not akin to the tasks performed in a banking and finance business by those charged with managing the debt book. Further, in a banking and finance business there would be employees also engaged in the fund raising side of the business, a task that is not required when the interposed treasury function is funded by equity and not external debt. Considered in isolation, these elements would likely suggest that it is reasonable to conclude that the requisite principal purpose exists.*

57. *However, these considerations would need to be weighed up against other facts and circumstances of the scheme and the matter specified in paragraph 832-725(2)(b) in determining whether paragraph 832-725(1)(h) is met.*

Example 4 – matter (c)

Background facts

58. *As for Example 3, however, assume that the loans made to group subsidiaries are not sourced from separate equity capital injections from Parent Co but rather Interposed Co has a mix of intra-group and external interest-bearing borrowings and also draws down on retained earnings from previous on-lending activities.*

59. *Due to the pooling of funds approach adopted by Interposed Co, Interposed Co is not able to readily identify the source of the payments, that is, equity on which the returns are non-taxable to Parent Co or interest-bearing borrowings.*

Analysis

60. *In this case, as Interposed Co borrows and on-lends with a view to making a profit on the margin of the on-lent principal, it is considered more likely that Interposed Co does*

engage in substantial commercial activities in carrying on a banking, financial or other similar business.

61. *This consideration would need to be weighed up against other facts and circumstances of the scheme and the matter specified in paragraph 832-725(2)(b) in determining whether paragraph 832-725(1)(h) is met.*

Interaction of matters taken into account

62. In the Commissioner's view where the matters in paragraphs 832-725(2)(b) and (c) present contrary conclusions, the relevant facts and circumstances in relation to the scheme (that is, the matter in paragraph 832-725(2)(a)) may influence the appropriate weighting. For example, if specific acquisition finance has been obtained via an entity that is engaged in a financial business which can be contemporaneously traced to an exempt source of funding (for example, equity funding) into the interposed foreign entity, such facts and circumstances would indicate that the matter in paragraph 832-725(2)(b) should hold greater significance or weight in determining the principal purpose test than those matters in paragraph 832-725(2)(c).

63. This accords with the comments contained in Example1.27 of the EM, which indicate that where an entity has a mix of sources of funding it may be difficult to determine a reasonable conclusion either way with respect to the principal purpose test having regard only to the second matter. Example 1.27 notes that if a fact existing in relation to the scheme indicates that the loan was not consistent with the interposed foreign entity's normal business practice, this could detract from the significance of the matter in paragraph 832-725(2)(c) and give more weighting to the matter in paragraph 832-725(2)(b) for determining the principal purpose test.

Back-to-back arrangements

64. Section 832-730 extends the targeted integrity rule to payments of interest made under back-to-back arrangements. The key elements are:

- there is a payment of interest to an entity
- that entity, or a further entity makes a payment of interest to a foreign entity, and
- the interest payments are made under an arrangement involving back-to-back loans or an arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.

65. A back-to-back arrangement can arise regardless of what rate of foreign income tax applies to the payment of interest received by the initial interposed entity. The purpose of the back-to-back rule is to determine which entity is effectively or economically entitled to that original payment of interest.

66. As explained in paragraph 1.358 of the EM, a back-to-back loan or economically equivalent arrangement would exist where the recipient of a payment has an effective obligation to pass on substantially all of the amount of the payment to another entity under another loan or similar arrangement. This obligation may be express or implied by the surrounding circumstances, including the relationship between the entities.

67. Ordinarily equity interests would not be expected to constitute part of an arrangement which is economically equivalent to a back-to-back loan, as returns on equity are discretionary and not obligatory. However, an exception to this may arise where entities are part of a fiscal unity, consolidated group, or otherwise subject to group relief such that the equity component of the arrangement is effectively disregarded for foreign income tax purposes. In that case, it is possible that an arrangement economically equivalent to a back-to-back loan could exist where the 'further entity' referred to in

paragraph 832-730(1)(b) is an entity which does not directly receive a payment of interest under the arrangement. For example, if B1 and B2 are entitled to group relief in country B, an arrangement involving a loan made by entity C1 to B1 and a loan made by B2 to A1 could be regarded as economically equivalent to a back-to-back loan notwithstanding that B2 is not contractually obligated to pass on payments received from A1. If that were the case, for the purposes of the targeted integrity rule the payment made by A1 is treated as if it had been made to C1.

68. With respect to the initial payment and the payment made by the final 'further entity' there is an element of tracing and nexus between the payments of interest required to demonstrate the existence of a back-to-back loan. Paragraphs 832-730(1)(a) and (b) both require the payments to be of a 'kind' mentioned in subparagraph 832-725(1)(d)(i) which refers to an expanded statutory definition of 'interest'. In particular, this inclusive definition includes payments (such as dividends) on hybrid instruments that are legal form equity but which are treated as debt interests for tax purposes.

69. Accordingly, in the Commissioner's view, the substance of the payment made by the interposed entity or the further entity needs to be tested and will constitute a payment of 'that kind' where it has the same tax effect for the interposed entity or further entity as the deductible interest payment has for Australian tax purposes for the original paying entity. Hybrid financial instruments that give rise to deductible payments to a foreign entity may therefore be considered to give rise to payments of that kind for the purposes of determining if the back-to-back arrangements rule applies.

70. As noted in paragraph 1.360 of the EM, it is expected that the terms of each loan would be substantially the same in order to be considered a back-to-back loan. We expect this to be the case in most back-to-back loans, but in the Commissioner's view it is not essential that the terms of the individual loans be identical and differences such as the currency in which the loan is denominated and the amount of the loan would not necessarily mean loans could not be part of a back-to-back arrangement. For example, multiple loans which are combined into a single on-lent amount may constitute an overall back-to-back loan arrangement.

71. The temporal connection between the loans is likely to be a significant factor in determining if they are part of a back-to-back arrangement, but again a disparity in issue dates would not of itself be conclusive that there is no back-to-back arrangement.

72. If an arrangement is a back-to-back loan or economic equivalent the targeted integrity rule applies as if the original interest payment is made directly to the foreign entity that is the final recipient of the interest payment under the back-to-back loan. Accordingly, each of the conditions in subsection 832-725(1) would be tested based on the assumption that the interest payment had been made to the final 'foreign entity' recipient, including the principal purpose test.

Commissioner of Taxation
5 April 2019

Appendix 1 – Your comments

73. You are invited to comment on this Draft Law Companion Ruling including the proposed date of effect. Please forward your comments to the contact officer by the due date.

Due date: **10 May 2019**

Contact officer details have been removed following publication of the final ruling.

References

ATO law topic	Tax integrity measures ~~ OECD issues
Legislative references	ITAA 1997 ITAA 1997 230-350(1) ITAA 1997 770-15(2) ITAA 1997 770-15(3) ITAA 1997 Div 820 ITAA 1997 Div 832 ITAA 1997 832-105 ITAA 1997 832-130 ITAA 1997 832-205 ITAA 1997 832-205(1)(a) ITAA 1997 Subdiv 832-C ITAA 1997 Subdiv 832-D ITAA 1997 Subdiv 832-E ITAA 1997 Subdiv 832-J ITAA 1997 832-725 ITAA 1997 832-725(1) ITAA 1997 832-725(1)(a) ITAA 1997 832-725(1)(b) ITAA 1997 832-725(1)(c) ITAA 1997 832-725(1)(d) ITAA 1997 832-725(1)(d)(i) ITAA 1997 832-725(1)(e) ITAA 1997 832-725(1)(f) ITAA 1997 832-725(1)(g) ITAA 1997 832-725(1)(h) ITAA 1997 832-725(2) ITAA 1997 832-725(2)(a) ITAA 1997 832-725(2)(b) ITAA 1997 832-725(2)(c) ITAA 1997 832-725(3) ITAA 1997 832-725(4) ITAA 1997 832-725(5) ITAA 1997 832-730 ITAA 1997 832-730(1)(a) ITAA 1997 832-730(1)(b) ITAA 1936 ITAA 1936 128A(1AB)

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Related Rulings/Determinations	LCR 2015/2 TR 2005/5
Other references	Revised Explanatory Memorandum to the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 Department of Treasury, 2017, *Mid-Year Economic and Fiscal Outlook 2017-18*, Commonwealth of Australia, Canberra
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