PCG 2019/6 - OECD hybrid mismatch rules - concept of structured arrangement

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Australian Government
Australian Taxation Office

Practical Compliance Guideline

PCG 2019/6

OECD hybrid mismatch rules – concept of structured arrangement

Relying on this Guideline

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this Guideline in good faith, the Commissioner will administer the law in accordance with this approach.

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What this Guideline is about

1. This Guideline contains practical guidance to assist taxpayers assessing the risk of the hybrid mismatch rules[1] applying to their circumstances, in particular in relation to the concept of 'structured arrangement' in section 832-210 of the ITAA 1997.[2]

2. The hybrid mismatch rules are intended to neutralise the effects of hybrid mismatches so that unfair tax advantages do not accrue for multinational groups as compared with domestic groups.[3] Whilst hybrid arrangements are most common in controlled group scenarios, it is also possible for a hybrid mismatch to arise between related or unrelated parties by way of a structured arrangement.[4]

3. As a result, there is scope for the rules to apply in these circumstances to deny a deduction or include an amount in assessable income where a payment giving rise to a hybrid mismatch is made under a structured arrangement.

4. This Guideline is focused on providing practical guidance to assist taxpayers in determining whether:

- the structured arrangement definition is satisfied, and
- if so, for particular hybrid arrangements[5] whether an entity will be a party to the structured arrangement

such that the hybrid mismatch rules could apply to deny a deduction or include an amount in a taxpayer's assessable income. In addition where the taxpayer is a party to the structured arrangement the imported mismatch rule[6] can apply from 1 January 2019 whereas otherwise application of the rule will be deferred by 12 months.

5. The structured arrangement definition is satisfied in respect of a payment giving rise to a hybrid mismatch where one of the following two limbs is satisfied:

- the hybrid mismatch is priced into the terms of a scheme under which the payment is made, or
- it is reasonable to conclude that the hybrid mismatch is a design feature of a scheme under which the payment is made.[7]

6. An outline of our views on the law is set out in Law Companion Ruling LCR 2019/3 *OECD hybrid mismatch rules – concept of structured arrangement*. This Guideline should be read in conjunction with LCR 2019/3.

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[1] A reference to the hybrid mismatch rules collectively refers to Division 832 of the *Income Tax Assessment Act 1997* (ITAA 1997) and associated amendments.
[2] All legislative references are to the ITAA 1997 unless otherwise indicated.
[3] Refer to paragraph 1.14 of the Revised Explanatory Memorandum to the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 (the EM).
[4] Refer to paragraph 122 of the OECD, 2014, *Public discussion draft: BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for Domestic Laws)*, OECD Publishing, Paris where it makes clear that the ambit of the measures should '… apply if the taxpayer is nevertheless a party to a structured arrangement that has been deliberately designed to engineer a mismatch between the holder and the issuer.'
[5] Relevant for the purposes of section 832-190 for a Subdivision 832-C hybrid financial instrument mismatch, section 832-295 for a Subdivision 832-D hybrid payer mismatch, section 832-385 for a Subdivision 832-E reverse hybrid mismatch, section 832-460 for a Subdivision 832-F branch hybrid mismatch, or section 832-615 for a Subdivision 832-H imported hybrid mismatch.
[6] Refer to Subdivision 832-H.
[7] Refer subsection 832-210(1).

Structure of this Guideline

7. This Guideline outlines:

- the testing time for determining when a scheme is a structured arrangement, when a payment has been made under a structured arrangement and when a taxpayer is required to test whether they are a party to a structured arrangement
- when a taxpayer is required to test a payment to determine whether it is made under a 'structured arrangement'
- relevant indicators for the Commissioner to determine that a hybrid mismatch is priced into the terms of a scheme under which a payment is made
- indicators that the Commissioner will consider relevant in determining that it is reasonable to conclude that the hybrid mismatch is a design feature of the scheme
- information the Commissioner will rely on and would expect to be available to taxpayers in determining if they are a party to the structured arrangement, and
- further practical examples where the structured arrangement qualification criteria would be satisfied.

8. The conclusions contained in this Guideline are specific to the facts and circumstances outlined in each example. The examples cannot, and do not, cover every possible circumstance where there may be a structured arrangement.

9. Taxpayers who are unsure whether an arrangement is a structured arrangement after having considered LCR 2019/3 and this Guideline may engage with us to discuss their particular circumstances via hybridmismatches@ato.gov.au.

Date of effect

10. This Guideline is effective from 1 January 2019. The use and application of this Guideline will be monitored regularly for three years after the date of its issue.

Testing time

11. Even though the term 'structured arrangement' is defined in subsection 832-210(1), the definition is also relevant for other subdivisions of Division 832.[8]

12. The Commissioner's view in relation to the identification a scheme is contained in paragraphs 12 to 20 of LCR 2019/3.

13. The question whether a payment is made under a structured arrangement should be considered whenever a payment is made, as the potential for the hybrid mismatch rules to apply must be determined in respect of each payment.[9] Accordingly, the testing time of whether a scheme is a structured arrangement cannot be limited to when the scheme was entered into. For example in the context of an imported hybrid mismatch[10], the relevant testing time will be whenever an importing payment is made following the relevant application date.

[8] The structured arrangement test is a scope requirement for hybrid mismatch arrangements addressed by Subdivisions 832-C, 832-D, 832-E, 832-F, 832-H and Subdivision 832-G (secondary response).
[9] Refer to paragraph 24 of LCR 2019/3.
[10] Refer to Subdivision 832-H.

14. Division 832 does not contain any transitional or grandparenting rules for structured arrangements. As such, structured arrangements that were in existence prior to the enactment of Division 832[11] will not be grandparented and are subject to the rules. For the purpose of applying Division 832, taxpayers are required to test whether a payment is made under a structured arrangement including for schemes entered into[12] prior to the application of the hybrid mismatch rules. A payment made in an income year commencing on or after 1 January 2019 will fall within the scope of these rules, even if the scheme under which the payment is made pre-dates the commencement date of the rules.

15. Notwithstanding strictly applied the law requires taxpayers to test for the existence of a structured arrangement each time a payment is made under a scheme, in practical terms the Commissioner recognises the significant compliance burden such an approach would entail. Accordingly, in practice the Commissioner would expect the relevant points in time for testing a structured arrangement to be broken down as follows:

- at inception of the scheme – whether a hybrid mismatch is priced into the terms of a scheme or whether it is reasonable to conclude that a hybrid mismatch is a design feature of a scheme should be answered by reference to the facts and circumstances in existence at the inception of the scheme
- if there is a material change in the terms of a scheme or to the facts and circumstances pertaining to or impacting the scheme, these changes may have a bearing on the pricing or design feature criteria to determine whether the definition of structured arrangement is satisfied at this point in time, and
- where the existence of a structured arrangement has been established, at either of the points in time above, the next question to be answered is whether the taxpayer is a party to the structured arrangement and this question should be considered whenever a payment is made under the arrangement in question.

16. Accordingly, the testing time of whether a scheme satisfies the definition of structured arrangement need not be limited to when the scheme was entered into but is best answered having regard to the point in time of its inception or when material change to the scheme has occurred. For example, in the context of an imported hybrid mismatch[13], one likely testing time would be when the scheme including the establishment of the relevant hybrid entities offshore was initiated. Testing whether you are a party to that scheme may be appropriate at that point in time if your involvement coincided with the set-up of the global structure. Alternatively, it may be appropriate to test whether you are a party to the arrangement at a later point in time (for example when the Australian entity becomes a participant in the scheme and, in the context of an imported mismatch, commences making imported mismatch payments).

17. The Commissioner accepts that where a series of payments are made under the same scheme, it would be likely that the conclusion reached about whether a particular payment under that scheme was made under a structured arrangement would also be reached in relation to other payments made under that same scheme. This assumes that the pricing and design features of the scheme remain unchanged for the other payments.

18. Where there is a subsequent change in the pricing or design features of the scheme, a taxpayer should retest the facts and circumstances surrounding the first payment following the relevant change as the change may be indicative of a new scheme.

[11] Generally, the hybrid mismatch rules will apply to assessments for income years starting on or after 1 January 2019. Refer to sections 832-10 and 832-15 of the *Income Tax (Transitional Provisions) Act 1997*.
[12] Having regard to any payments that would be made under the scheme.
[13] Subdivision 832-H.

A significant change in external factors, such as market conditions, may also trigger a change in pricing or a design feature of the scheme necessitating retesting.[14]

19. In respect to traded instruments, the Commissioner would accept that there is not an obligation to retest whether the structured arrangement definition is satisfied from the issuer's perspective each time the instrument is traded on-market unless there is a material change in the investor base (for example, in the context of a takeover).

'Priced into the terms' limb of the definition – relevant indicators

20. Whether a hybrid mismatch has been priced into the terms of a scheme is a question of fact. This limb of the structured arrangement definition requires an examination of the terms of the instrument, arrangement or dealings, and pricing of risk versus return between the parties to the scheme.

21. Where any of the following are included in the terms, the Commissioner would consider these to be relevant indicators that a hybrid mismatch has been priced into the terms of the scheme:

- a formula that explicitly references the tax rate of one of the parties to the transaction in the allocation of risk and reward under the arrangement
- pricing that is divergent from market rates where the difference is readily explicable with reference to a hybrid mismatch
- a gross-up clause representing (in whole or part) compensation for any additional tax payable where the hybrid mismatch turns out to not be available to one of the parties
- a renegotiation clause allowing one of the parties to alter their pricing if the hybrid mismatch turns out to not be available
- a break clause allowing one of the parties to terminate the arrangement if the tax benefits resulting from the hybrid mismatch do not materialise, or
- pricing on a product ostensibly widely offered but only taken up in a particular jurisdiction explicable by reference to a hybrid mismatch outcome in that jurisdiction.[15]

22. Whilst not exhaustive, this list provides examples of terms which the Commissioner would consider as potential indicators of a hybrid mismatch being priced into the terms of a scheme for the purposes of these rules.

23. As a matter of practical application, the Commissioner will focus on whether there is demonstrable evidence that the hybrid mismatch has been priced into the terms of the scheme, rather than merely benchmarking a price without the hybrid mismatch and attributing any deviation from that price to the hybrid mismatch. That said, there may be cases where a significant deviation from other prices in the market is only explicable by the hybrid mismatch.[16]

24. Evidence, may include, for example, documented contractual terms of the arrangements that define how the risks and benefits are to be divided between parties, or documentation or advice which outlines how the arrangements were negotiated and the tax considerations were taken into account.

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[14] Similarly in relation to whether an entity is a party to a structured arrangement a change in surrounding facts and circumstances could alter the finding under subsection 832-210(3).

[15] Conversely market pricing on a widely offered product taken up in different jurisdictions should serve as an indicator that the hybrid mismatch was not priced into the scheme.

[16] This accords with the commentary in paragraph 323 of 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 (OECD Action 2 Report) and paragraph 27 of LCR 2019/3.

'Design feature' limb of the definition – relevant factors

25. Whether it is reasonable to conclude that the hybrid mismatch is a design feature of a scheme is an objective test which is based on the facts and circumstances of the arrangement. It is a wider test than that in paragraph 832-210(1)(a).[17] Essentially under this alternative limb of the definition, one must make an objective assessment based on the relevant facts and circumstances whether the hybrid mismatch was intended. This is consistent with Chapter 10 of the OECD Action 2 report where the threshold test in this context is whether the facts and circumstances (including the terms) of the arrangement indicate that is has been designed to produce a hybrid mismatch.[18]

26. The Commissioner would view any of the following factors (either on a stand-alone basis or in combination) as indicating that the hybrid mismatch was a design feature of the scheme for the purposes of the second alternative limb of the structured arrangement definition:

- Advice has been sought regarding planning to produce a hybrid mismatch in a particular scheme or structure. This may include written or oral advice, or working papers and documents produced prior to the scheme being implemented indicating that the hybrid mismatch was intended.
- A term, step or transaction included in the scheme explicable by reference to the hybrid mismatch. For example, under this factor the commercial objectives of the scheme would have been achieved regardless of whether the step was included.
- An arrangement or investment is marketed as a tax advantaged product where some or all of the tax advantage is explicable or sourced by reference to the hybrid mismatch. When determining whether this factor is present the Commissioner would look to whether the potential tax benefits have been communicated (for example, in marketing materials or product disclosure statements) to prospective investors or participants.
- Where the product has only been offered or marketed to a particular subset of prospective investors or participants (for example, a particular type or in a particular jurisdiction) that would be expected to benefit from such a hybrid mismatch. The fact that it would be uneconomic for the taxpayer to enter into the scheme but for the benefit under the hybrid arrangement would strongly indicate not only satisfaction of the 'priced into the terms' limb but potentially also the 'design feature' limb.
- In the context of a Subdivision 832-H imported hybrid mismatch, a transaction chain traceable (directly or indirectly) from the deductible importing payment to the offshore hybrid mismatch. For these purposes where elements of the chain are not contemporaneous, the design feature condition may nevertheless be satisfied on the basis, for example, that the deductible importing payment might just be the last link in a transaction chain with the requisite design intent. The importing payments will be considered to be part of a scheme where they are part of a coordinated group arrangement evidencing a nexus between the payments and the offshore hybrid mismatch.

27. Whilst not exhaustive, this list is intended to provide guidance when a hybrid mismatch is a design feature of a scheme based on whether particular factors contributing to the hybrid mismatch were included intentionally or deliberately.

[17] Refer to paragraph 1.140 of the EM, paragraph 326 of the OECD Action 2 Report and paragraph 30 of LCR 2019/3.
[18] Refer to paragraph 36 of LCR 2019/3.

28. Absent evidence of a hybrid mismatch being a design feature of a scheme, the requisite intent is not to be assumed merely because a deduction/non-inclusion mismatch or a deduction/deduction mismatch outcome arises as a matter of fact. For example, there needs to be demonstrable evidence of an intention to achieve both the non-inclusion of income and a deduction in order for the 'design feature' limb to be satisfied.

Party to the structured arrangement – information available to taxpayer

29. Particular hybrid mismatches to which the rules apply also have an exception provision for taxpayers who might otherwise be subject to these rules. If a payment is made under a structured arrangement, the operative provision will only apply if the entity is a party to the structured arrangement.[19]

30. Essentially, if the taxpayer (or a member of its Division 832 control group) could not reasonably have been expected to be aware of the hybrid mismatch and did not benefit from the mismatch, it will not satisfy the condition of being a party to the arrangement.

31. Whether an entity is a party to a structured arrangement is an objective test largely based on the information available to the taxpayer and members of its Division 832 control group. This test does not impose an obligation on a taxpayer to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable person making a risk versus return assessment. In the Commissioner's view it is reasonable to expect, when applying the test as to whether they are a party to the arrangement, the taxpayer to have access to information relating to their own dealings including correspondence, the terms of an instrument or arrangement, advertising, public documentation (for example, prospectus or investment memorandum), the location and tax residence of transaction counterparties, and some awareness of market pricing of their risk/return position.

32. In the Commissioner's view it is reasonable to expect a taxpayer to make general enquiries of a foreign counterparty's tax residence and the income tax treatment of a payment from their perspective in that location. Such enquiries may include questions of timing of recognition of income where the arrangement in question viewed objectively would have scope to enable the deferral of inclusion in the recipient's tax base (for example, for a deeply discounted security).

33. Furthermore, where a sophisticated taxpayer (for example, a bank or a financial institution) issues (or holds) a financial instrument with a counterparty in a foreign jurisdiction it would be reasonable to expect the issuer to be aware of whether the instrument would generally be viewed as debt or equity in the foreign jurisdiction and where viewed as equity, whether there is a participation exemption for equity instruments under the tax laws of the foreign jurisdiction.

34. Where it is reasonable to expect that a taxpayer would be aware that they have either financially benefited from the mismatch or shared in the value, they would be taken to satisfy the test that they are a party to the structured arrangement. For example if the pricing of an arrangement is divergent from the market, then the Commissioner would expect that the taxpayer would make general enquiries to satisfy themselves whether the pricing benefit is a function of the value of a hybrid mismatch being shared.

35. It is conceivable that a taxpayer may become party to a structure arrangement after the scheme was initially entered into where they subsequently become privy to information that a scheme gives rise to a hybrid mismatch to which they are receiving a financial

[19] Refer to section 832-190 (for a Subdivision 832-C hybrid financial instrument mismatch), section 832-295 (for a Subdivision 832-D hybrid payer mismatch), section 832-385 (for a Subdivision 832-E reverse hybrid mismatch), section 832-460 (for a Subdivision 832-F branch hybrid mismatch), or section 832-615 (for a Subdivision 832-H imported hybrid mismatch).

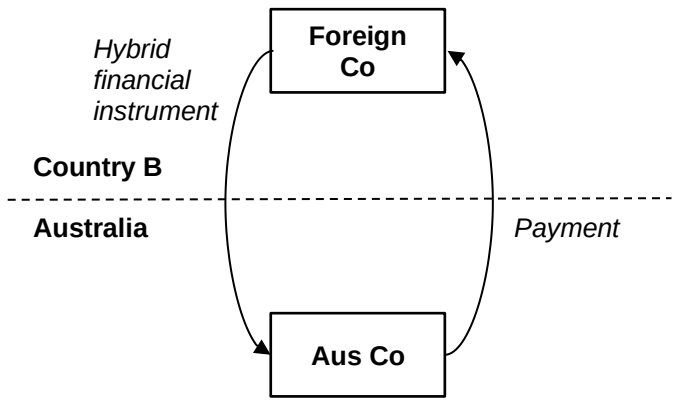
benefit. As such, taxpayers are required to consider whether they are party to a structured arrangement whenever they make a payment under the arrangement.

Examples

36. The following examples have been included to provide practical guidance regarding when the Commissioner would consider a structured arrangement would exist and when a taxpayer would be party to the structured arrangement. This includes the types of factors that would be taken into account when determining if a hybrid mismatch has been priced into the terms or is a design feature of a scheme.

37. It is important to note that the examples outlined in this Guideline are not an exhaustive list and that the analysis of whether the scheme is a structured arrangement is dependent on the background facts and assumptions included in each example.

Example 1 – hybrid financial instrument mismatch



Background facts

38. *Foreign Co subscribed for bonds issued by Aus Co prior to the enactment of the hybrid mismatch rules. Foreign Co is unrelated to Aus Co. Aus Co treats the bond as a debt interest for the purposes of Division 974 and, but for the hybrid mismatch rules, would have expected to be entitled to a deduction in Australia for interest on the loan from Foreign Co. Foreign Co subscribed for the bonds after receiving an investment memorandum which included a summary of the expected tax treatment of the instrument in Australia.*

39. *Interest on the bonds is payable annually in arrears based on the following formula:*

$$(\text{London Inter-Bank Offered Rate} + \text{arm's length margin}) \times (1 - (25\% \times 50\%))$$

40. *Foreign Co is a tax resident of Country B with a tax rate of 25%. In Foreign Co's hands under the laws of Country B, the bond is treated as an equity instrument and the 'interest' will be exempt from income tax in Country B. Foreign Co and Aus Co have agreed to evenly share the benefit associated with the hybrid mismatch (resulting from the deduction/non-inclusion (D/NI) mismatch).*[20]

[20] That is, broadly, a deduction being received for a payment in one country, where the corresponding income is not assessable income or included in the tax base in another country (refer to paragraph 5 of LCR 2019/3).

Analysis

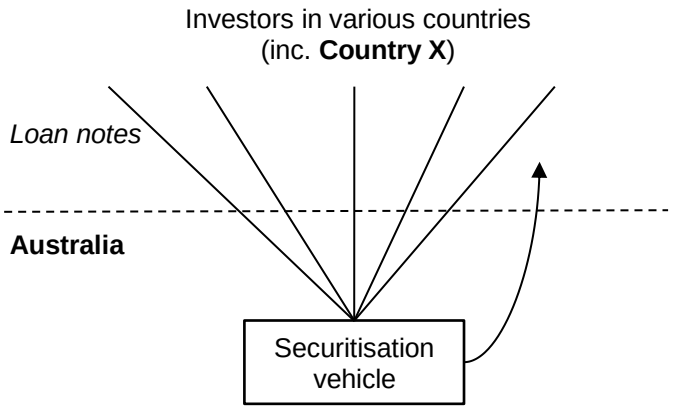
41. *The relevant facts and circumstances would include the choice of instrument, the terms and the pricing of the bond issued by Aus Co to Foreign Co together with correspondence and negotiations regarding the agreed return on the bond. It would also be relevant to consider the particular features of the bond and rights / obligations of the parties whereby the instrument was treated as (deductible) debt for Australian tax purposes and (non-assessable) equity for Country B tax purposes.*

42. *A payment will be treated as being made under a structured arrangement where the hybrid mismatch has been priced into the terms of the scheme (that is, under the first alternative limb of the definition a structured arrangement). In this case, the terms of the bond directly reference the tax rate for Foreign Co in Country B explicitly, by way of a formula that discounts the market interest rate by an agreed proportion of the tax benefit resulting from the hybrid mismatch. Accordingly, a payment made under this scheme would satisfy the first limb of the definition.*

43. *The conditions under which the bonds have been issued would also indicate that the second alternative limb of the definition would be satisfied. The explicit terms of the bond including the interest formula combined with the shared understanding of the bond being a tax advantaged product (evidenced by the correspondence and dealings) would be relevant facts for the purposes of this limb.*

44. *Aus Co would also qualify as a party to the scheme on the basis that it was aware that the tax benefit has been explicitly priced into the return.*

Example 2 – securitisation vehicle



Background facts

45. *An Australian lender originates home loans as part of its ordinary financing business. As part of its business model by which it sources funding and manages risk, the Australian lender establishes a securitisation vehicle (SV) and then assigns to the SV in exchange for cash consideration a portfolio containing home loans it has originated.*

46. *The SV funds the cash consideration for the equitable assignment out of the proceeds from the issue of mortgage-backed loan notes by the SV. The SV has marketed these mortgage-backed loan notes at different risk ratings to investors in various countries. This includes investors who are residents of Country X.*

47. *The different tranches of notes are priced according to the degree of risk they carry, taking into account where they sit in the credit risk waterfall (that is their relative level of subordination).*

48. *The terms of the notes do not include any specific references to tax attributes or particular tax outcomes in any jurisdiction (apart from withholding tax warranties) issue. The term of the notes is five years from the date of their issue.*

49. *In Australia, for taxation purposes from the perspective of SV and any Australian resident note holders, the notes would qualify as debt interests for income tax purposes and the returns would ordinarily be expected to be deductible to SV*[21] *and assessable to an Australian resident note holder (subject to Division 230) on an accruals basis. There is nothing in the terms of the arrangement (beyond the risk rating of the notes) that would suggest accumulating returns on the note would not be generally be assessable on an accruals basis in investors' home jurisdictions.*

50. *However, from the perspective of Country X, the lowest-ranked tranche of notes would attract a different tax characterisation such that the return on the notes would be assessed to tax on a realisation basis. In other words, the interest would only be included in the tax base of residents of Country X when paid.*

51. *Accordingly, in the context of the hybrid financial instruments rule in Subdivision 832-C, there may be a D/NI hybrid mismatch for interest accrued, assuming the SV does not pay returns to note holders until redemption and the redemption date is later than 12 months after the end of the income year in which the deductions arise for the SV.*[22] *As a result, the question to be answered is whether the arrangement satisfies the structured arrangement scope requirement for Subdivision 832-C to apply.*

Analysis

52. *The relevant facts and circumstances surrounding the scheme would include the choice of instrument, the terms, tax residency and legal form of the SV, the tax residency of each investor, the pricing of the different tranches of notes and the manner in which the notes have been marketed.*

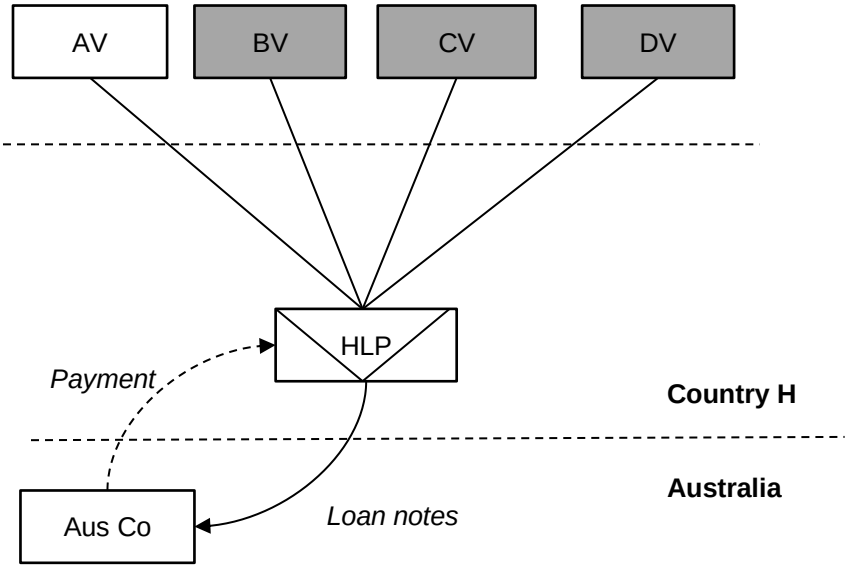
53. *On the basis that the lowest-ranked tranche of notes has been marketed widely, and has been taken up by a variety of investors in different countries with consistent pricing across those jurisdictions, there would be nothing to suggest that the hybrid mismatch arising in Country X has been priced into the terms of the lowest-ranked mortgage loan notes. Nor would it be reasonable in this context to suggest, given the wide offering and the wide take up of the notes, that the deferred assessability in the hands of a Country X tax resident was a design feature of the note issue.*

54. *Furthermore consistent pricing across different jurisdictions (including some jurisdictions that will have assessed the income on the notes to tax on an accruals basis) may be relevant to support the position that the resultant hybrid mismatch would not satisfy the first or second limbs of the structured arrangement definition.*

55. *However, if for example, the SV specifically targeted investors who are resident of Country X regarding the marketing, pricing*[23] *or take-up of the most subordinated tranches of notes then in these circumstances, it might lead to a different conclusion. Considered as part of the facts and circumstances, this would be relevant in determining whether it is reasonable to conclude that the hybrid mismatch is a design feature of the notes issue and therefore whether the interest payments are made under a structured arrangement.*

[21] But for any potential application of the hybrid mismatch rules.
[22] Also assuming the hybrid requirement in section 832-220 is also met.
[23] For example, if the pricing of the notes was readily explicable by reference to the tax deferral, this would also indicate that the hybrid mismatch has been priced into the issue of the notes.

Example 3 – reverse hybrid mismatch



Background facts

57. *A fund (H Limited Partnership (HLP)) is established in Country H for the purposes of providing a collective investment vehicle for debt interests. HLP is treated as transparent for Country H purposes (that is, Country H regards the partners in HLP as liable to tax in respect of HLP's income and profits).*

58. *Upon review of the investment memorandum, investment vehicles (AV, BV, CV, and DV) established respectively in countries A, B, C, and D, each invest as limited partners in HLP. Country A (and thus AV) views HLP as transparent for tax purposes. However, under the laws of Country B, C and D, HLP is treated as an entity liable to tax on its own income and profits separate to the partners' liability to tax on their own income or profits. As a result, income derived by HLP is not subject to foreign income tax in Country H or Countries B, C or D.*[24] *Furthermore, neither BV, CV nor DV is subject to foreign income tax on amounts that are distributed to them by HLP. This is on the basis that the partnership distributions are treated as dividends paid by a controlled foreign company and accordingly attract respective participation exemptions in Countries B, C and D.*[25]

59. *Investing through HLP has been marketed as a tax-advantaged product to investors in Countries B, C and D. The investment memorandum includes a description of the expected tax consequences for investors in those countries, specifically including a reference to the expectation that HLP should be viewed as a separate taxable entity and that returns should be treated as exempt from tax if investors hold the requisite interests. These features were promoted in marketing materials released alongside the investment memorandum.*

60. *Aus Co is a tax resident of Australia, and not related in any other way to AV, BV, CV and DV other than via its arrangements with HLP. Aus Co has loan notes on issue which are acquired by HLP shortly after its establishment. The loan notes are issued on arm's length commercial terms and bear a market interest rate. The establishment of HLP and the marketing material used for the purposes of attracting its capital is not relevant to and is not used by HLP in the process of acquiring the loan notes issued by Aus Co.*

[24] Also assumes Countries B, C and D do not recognise the income or profits of HLP under a controlled foreign company regime, in respect of DV (or any other entity).

[25] Assume the participation threshold is 10% and that BV, CV and DV effectively hold at least 10% of the partnership interests of HLP.

61. *HLP acquired the loan notes with the knowledge that they would be treated as debt in Australia and therefore the interest payment would be deducitble to Aus Co.*

62. *But for the potential application of the hybrid mismatch rules the interest payments on the loan would be expected to be deductible under section 8-1 to Aus Co.*

63. *Assume for the purposes of the hybrid mismatch rules that HLP is a reverse hybrid*[26] *and that the payment made by Aus Co gives rise to a D/NI mismatch (to the extent of the non-inclusion of the receipt of income from BV, CV and DV's perspectives).*

Analysis

64. *The relevant scheme for the purposes of considering whether there is a structured arrangement includes the establishment of HLP*[27] *with its specific entity characteristics (that is, establishment as a limited partnership in Country H), the issue of the limited partnership interests to AV, BV, CV and DV and the lending of the funds by HLP to Aus Co which are deductible to Aus Co.*

65. *The facts and circumstances that exist in connection with the scheme indicate that the payment of interest by Aus Co is made under a structured arrangement on the basis that it is reasonable to conclude that the hybrid mismatch was a design feature of that scheme. In particular, the fact that the HLP investment memorandum contained specific references to the tax advantages that may be achieved via the hybrid mismatch outcome for investors from countries B, C and D suggests that the hybrid mismatch*[28] *was a design feature of the scheme under which the interest payment from Aus Co is made.*

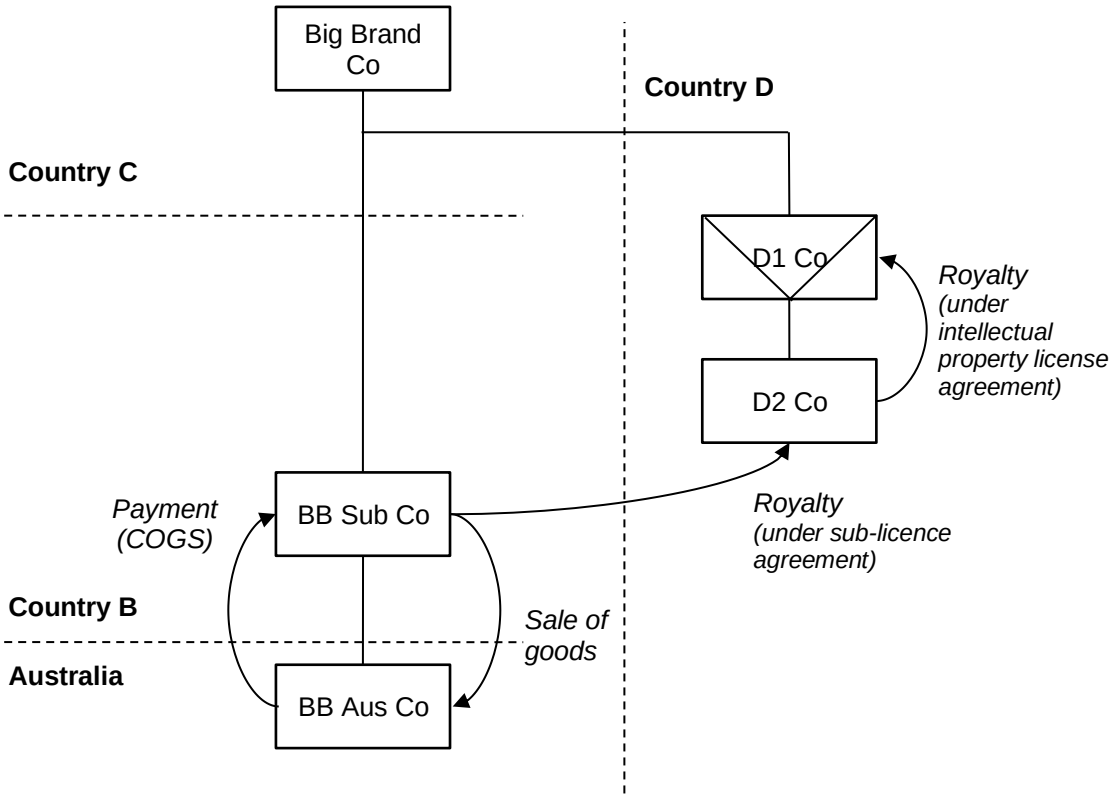
66. *However, in determining whether Aus Co is a party to the structured arrangement*[29] *it is necessary to investigate the arrangement from Aus Co's perspective. This is an objective test focussed on what Aus Co could reasonably be expected to have been aware of when it entered into the scheme (that is, when its loan notes were acquired).*

67. *It is not expected that Aus Co would have to seek further information in respect of HLP's establishment unless it is relevant to its loan notes. That is, the Commissioner would not expect Aus Co to undertake additional due diligence above and beyond what would be reasonably expected ordinarily in this instance regarding risk and reward in relation to its own financial position. As Aus Co has not received a financial benefit (as demonstrated by its arm's length terms and market pricing), it would not be expected that Aus Co would have to make any additional general enquiries about the tax treatment of the payment for HLP. However, where Aus Co has received a financial benefit for example by way of a price at odds with the market, Aus Co would need to make enquires about how the payment is treated in Country H.*

68. *This conclusion can be contrasted with a situation where, for example, Aus Co was involved with the general partner of HLP prior to the establishment of HLP and was part of the establishment process in relation to HLP. Such a relationship would make it reasonable to expect that Aus Co was aware that the scheme gave rise to a reverse hybrid mismatch. As such, Aus Co could be considered a party to the structured arrangement.*

[26] Section 832-375 which is the guide to Subdivision 832-E provides that 'An entity is a reverse hybrid if it is transparent for the purposes of the tax law of the country in which it is formed, but non-transparent for the purposes of the tax law of the country in which investors in it are subject to tax (resulting in non-inclusion)'.
[27] Establishment by the general partner, which is assumed to have a minor interest in HLP.
[28] The reverse hybrid mismatch under Subdivision 832-E.
[29] And therefore whether the exception in section 832-385 applies.

Example 4 – imported hybrid mismatch



Background facts

69. *The Big Brand Group holds intellectual property (IP) in D1 Co. D1 Co grants a licence to D2 Co to exploit the IP in exchange for royalties. In turn, D2 Co grants a sub-licence to BB Sub Co in exchange for a royalty.*

70. *Pursuant to the sub-licence agreement, BB Sub Co utilises the IP and manufactures goods which are sold to BB Aus Co, a wholly owned member of the Big Brand group of companies. BB Aus Co, acting as a local market limited risk distributor, sells the goods to customers in Australia and but for the potential application of the hybrid mismatch rules, would expect to be entitled to a deduction in Australia for the costs of those goods purchased.*

71. *The amount received by BB Sub Co for the goods is subject to foreign income tax in BB Sub Co's hands in Country B though that income will largely be offset by the amount of the foreign income tax deduction in Country B for the royalty paid to D2 Co (the amount of such royalty being subject to foreign income tax in Country D in the hands of D2 Co). D2 Co is then entitled to a deduction in Country D for the amount of the royalty paid to D1 Co.*

72. *D1 Co is a resident of Country D and is wholly owned by Big Brand Co (a resident of Country C). D1 Co is regarded as transparent from the perspective of Country D's income tax law but opaque from the perspective of Country C. As a result the profits of D1 Co are not subject to tax in either Country C (including under Country C's controlled foreign company (CFC) rules) or Country D.*

73. *Big Brand Co intended to hold IP in D1 Co so that any future payments made either directly or indirectly by Big Brand Co's foreign subsidiaries (as its global reach expanded) to D1 Co, would result in this deduction/non-inclusion outcome being imported to the relevant jurisdiction, and therefore lowering the overall effective tax rate of the group. Accordingly, the decision to exploit the IP internally and the decision to manufacture the goods in Australia were not independent. There was an overall causal nexus between the payments. The importation of the mismatch into Australia does not occur by chance but*

rather is by design or part of a coordinated plan, one which might pre-date the decision to include BB Aus Co in the plan.

Analysis

74. *D1 Co is a reverse hybrid with respect to the royalty payments from D2 Co that give rise to a D/NI mismatch.*[30]

75. *The royalty payments from D2 Co to D1 Co give rise to an offshore hybrid mismatch. BB Sub Co is an interposed entity, D2 Co is an offshore deducting entity and the payment by BB Aus Co to BB Sub Co for their cost of goods sold is an importing payment in relation to the offshore hybrid mismatch.*

76. *The importing payments made by BB Aus Co will be covered by item 1 of the table in subsection 832-615(2) (the priority table for importing payments) and thereby allocated the highest priority in the application of the importing mismatch rule in Subdivision 832-H if the importing payments are made under a structured arrangement.*

77. *In determining whether the importing payment is made under a structured arrangement the relevant facts and circumstances would include:*

- *the sales agreement and related purchase of goods by BB Aus Co from BB Sub Co and the amount paid*
- *the IP sub-licence agreement between BB Sub Co and D2 Co and the royalty payments made by BB Sub Co to D2 Co*
- *the tax residence of the parties to the scheme*
- *the tax treatment of payments in the relevant jurisdictions in the chain; the IP licence agreement between D2 Co to D1 Co and the royalty payments made from D2 Co to D1 Co, and*
- *coordination by Big Brand Co of the overall arrangement.*

78. *The royalty payments made by BB Sub Co to D2 Co and by D2 Co to D1 Co are for the exploitation of the IP. BB Sub Co utilises the IP to manufacture the goods sold to BB Aus Co which then on-sells to the local Australian market.*

79. *There is a clear commercial/business nexus between the licence and sub-licence agreements and royalty payments and the sale of goods by BB Sub Co to BB Aus Co. The sale of goods by BB Sub Co is commercially dependent on the sub-licence of IP by D2 Co which is in turn commercially dependent on the licence of IP by D1 Co. It would be reasonable to conclude that it was Big Brand Co's intention to import the D/NI mismatch into jurisdictions as it expanded globally (including Australia) and that there is a causal nexus between the payments, as Big Brand Co has established similar structures in other jurisdictions with importation of the hybrid mismatch into those jurisdictions also. The underlying licence agreements in permitting the use of the IP in the manner so used (that is, sub-license or manufacture and distribute) confirm that the individual arrangements comprising the scheme are not isolated and unconnected, but rather have such a nexus which could to support a reasonable conclusion that the hybrid mismatch was a feature of the scheme that also comprised the individual arrangements and the respective payments.*

80. *In the circumstances it is reasonable to conclude that there is a unifying thread or a nexus between the importing payment (for cost of goods sold (COGS)) made by BB Aus Co to BB Sub Co, the royalty payment by BB Sub Co to D2 Co and the royalty payment by D2 Co to D1 Co. On that basis it would be reasonable to conclude that creating the hybrid mismatch (that is, pursuant to section 832-620, the importing payment in relation to the*

[30] Assuming Country C does not recognise the income or profits of D1 Co or D2 Co (or any other entity) under a CFC regime.

offshore hybrid mismatch) was deliberate and therefore a design feature of the scheme. As a consequence, the importing payment should be treated as having been made under a structured arrangement pursuant to the definition in section 832-210 for the purpose of the priority table for importing payments in subsection 832-615(2).

81. *The payments are all part of a scheme whereby the D/NI mismatch arising between D1 Co and Big Brand Co is imported into Australia. In effect, the result is that the deduction element of the D/NI outcome is the deduction that would otherwise have been available to BB Aus Co at 30%.*

82. *To be able to demonstrate that the hybrid mismatch was not a design feature in the context of the structured arrangement definition, it would require one to conclude, based on the facts, that the creation of the hybrid mismatch (including its importation into Australia) was inadvertent. It is not considered that this conclusion would be reasonable based on these facts.*

83. *From BB Aus Co's perspective, in order for the hybrid mismatch rules to impact its entitlement to a COGS deduction in these circumstances, it will be party to the structured arrangement for the purposes of these rules, unless it can satisfy all of the three criteria in subsection 832-210(3), that is, that:*

- *BB Aus Co could not reasonably have been expected to be aware that the scheme gave rise to a hybrid mismatch, and*
- *no other entity in the Big Brand Division 832 control group could reasonably have been expected to be aware that the scheme gave rise to a hybrid mismatch, and*
- *in addition, the financial position of each entity in the Big Brand Division 832 control group would reasonably be expected to have been the same if the scheme had not given rise to the mismatch.*

84. *In this case, BB Aus Co, BB Sub Co, D2 Co, D1 Co and Big Brand Co are all members of the same Division 832 control group, and at least one of the entities would reasonably have been expected to be aware that the scheme gave rise to the hybrid mismatch (and would have benefited financially from the mismatch). Accordingly, from BB Aus Co's perspective the payment to BB Sub Co has been made under a structured arrangement and BB Aus Co will be taken to be a party to that arrangement. As a result there will be scope for the imported mismatch rule to apply to impact BB Aus Co's entitlement to a deduction relating to its COGS expense.*

Commissioner of Taxation
24 July 2019

References

Previous draft:

Previously released in draft format as PCG 2018/D9

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