PCG 2018/D4 (Finalised) - Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements

This document has been finalised by PCG 2018/7.

Part IVA of the *Income Tax Assessment Act 1936* and restructures of hybrid mismatch arrangements

Relying on this draft Guideline

This Practical Compliance Guideline is a draft for consultation purposes only. When the final Guideline issues, it will have the following preamble:

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 draft Guideline is about

1. This draft Guideline sets out the Australian Taxation Office's compliance approach with respect to Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) and certain restructures that have the effect of preserving Australian tax benefits that would otherwise be disallowed with the enactment of the hybrid mismatch rules.[1]

2. The hybrid mismatch rules implement into Australian taxation law the recommendations of the Organisation for Economic Cooperation and Development (OECD).[2] The rules are intended to deter the use of certain hybrid arrangements that exploit differences in the tax treatment of an entity or financial instrument under the income tax laws of two or more countries.

3. The enactment of the rules with a deferred date of commencement is intended to allow taxpayers time to review their existing hybrid arrangements and to unwind or restructure out of such arrangements in advance of the rules if they so choose.

4. Concerns have been raised about the potential for the Commissioner to apply Part IVA of the ITAA 1936 to cancel all or part of a tax benefit where a taxpayer restructures an existing hybrid arrangement to avoid the potential application of the hybrid mismatch rules. This may involve, for example, replacing a hybrid financing instrument with a debt instrument to eliminate tax benefits in another country but preserve tax benefits, in the form of deductible debt, in Australia.

5. This draft Guideline is designed to assist taxpayers to manage their compliance risk in these circumstances where their intention is to eliminate hybrid outcomes. It does so by outlining restructuring that the Commissioner considers to be of 'low risk' and to which he would not seek to apply Part IVA of the ITAA 1936.

6. The description of low risk arrangements is illustrated by scenarios involving straight-forward restructuring that merely removes the hybrid element of existing arrangements whilst keeping the surrounding facts and circumstances unchanged (for example, relevant nexus to the derivation of assessable income). This reflects the purpose of this draft Guideline to provide assurance that has been sought in respect of this type of restructuring in terms of Part IVA of the ITAA 1936. It is not intended to provide more detailed technical guidance on when Part IVA of the ITAA 1936 could potentially apply to more complex restructuring scenarios. Such guidance would be of limited practical utility given the nature of Part IVA of the ITAA 1936 and the overriding importance of facts and circumstances in the particular case.

Date of effect

7. This draft Guideline will become effective from the date of enactment of the hybrid mismatch rules and apply to restructuring arrangements entered into before and after that date.

[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] OECD/G20 Base Erosion and Profit Shifting Project – Neutralising the Effects of Hybrid Mismatch Arrangements - Action 2 2015 Final Report.

8. The use and application of this draft or finalised Guideline will be under continuous review over the next three years.

Compliance approach

9. The character of schemes before and after any change, rather than the fact of change, will generally determine the application of Part IVA of the ITAA 1936. Where a taxpayer has engaged in ordinary commercial dealings before a change and engages in ordinary commercial dealings after the change, the fact that the change preserves a tax benefit will generally have no significance. This is because a tax avoidance purpose will not be inferred from normal business dealings just because a tax benefit is obtained as a result.[3]

10. For the same reason, the alteration of a contrived scheme to one that is an ordinary dealing (albeit one that results in the obtaining of a tax benefit) would not ordinarily invite an inference that the main purpose of the new dealing is to obtain the benefit. Obviously, if the scheme after the change is in itself contrived, different considerations arise, and schemes that are contrived before and after the change will naturally invite the closest examination.

11. In the context of hybrid arrangements, where a restructured arrangement no longer gives rise to a hybrid mismatch (that is, a deduction/non-inclusion (D/NI) or double deduction (DD) outcome), the hybrid mismatch rules will have no application and an Australian tax benefit may be obtained as a result. In such a case, the replacement arrangement would be considered low risk in terms of Part IVA of the ITAA 1936 where the restructure merely removes the hybrid mismatch outcome and the arrangement is itself an ordinary commercial dealing or structure without contrived features that would attract Part IVA of the ITAA 1936.

12. Elimination of mismatch outcomes means there is an expectation that if the Australian tax implications are preserved, then the tax benefits in the foreign counterparty jurisdiction will no longer be available. Accordingly, under a D/NI scenario, where the tax benefit in Australia takes the form of deductions, we would expect to see that the corresponding income is subject to tax in the other country. Alternatively, where the tax benefit in Australia takes the form of non-inclusion of assessable income, we would also expect to see that the deduction is no longer available in the other country. In a DD scenario, we would expect to see that the deduction is no longer available in the other country.

13. To help you manage your compliance risk with respect to Part IVA of the ITAA 1936, this draft Guideline outlines a number of restructuring scenarios to illustrate the types of arrangements that meet the low risk description above. These low risk scenarios involve restructuring that merely eliminates a D/NI or DD outcome and preserves an Australian tax benefit that would otherwise be denied under the hybrid mismatch rules.

14. It is important to note that this low risk characterisation is predicated on the arrangement otherwise being an ordinary commercial dealing. Accordingly, this draft Guideline also includes higher risk scenarios to illustrate that removing the hybrid element of an arrangement will not preclude scrutiny of the arrangement if it is one that otherwise has features of artificiality or contrivance giving rise to Part IVA of the ITAA 1936 considerations.

[3] *Commissioner of Taxation v Hart* (2004), 217 CLR 216 at p.227 at [15].

15. Furthermore, it should not be assumed[4] that restructuring arrangements in anticipation of the rules will necessarily be considered low risk and not subject to scrutiny by the ATO merely because they were entered into prior to enactment of the hybrid rules, particularly where such arrangements continue to be carried out and given effect after enactment. In this regard, it is important to note the relevance of matters in subsection 177D(2) of the ITAA 1936 that specifically look forward to the *result* that would be achieved by a scheme in relation to the operation of the Act or in terms of changes in financial position of relevant entities. It is the character of the scheme entered into or being carried out that will generally determine the application of Part IVA of the ITAA 1936.

Low risk scenarios

16. Each of the following scenarios includes a description of the original hybrid arrangement before the restructure and the replacement arrangement following the restructure. The scenarios contain minimal facts as it is not the intention of this draft Guideline to prescribe all the possible combinations or sequences of steps that may or may not be acceptable under each scenario. The following assumptions, however, apply to all low risk scenarios.

(a) There is no change to the jurisdictions of the entities involved under the replacement arrangement.

(b) The original arrangement makes commercial sense for the parties involved (in that prior to the restructure it would not have attracted the application of Part IVA of the ITAA 1936).

(c) The replacement arrangement makes commercial sense for the parties involved.

(d) The restructure and replacement arrangement are effected in a straightforward way having regard to the circumstances.

(e) The restructure and replacement arrangement are implemented on arm's length terms.

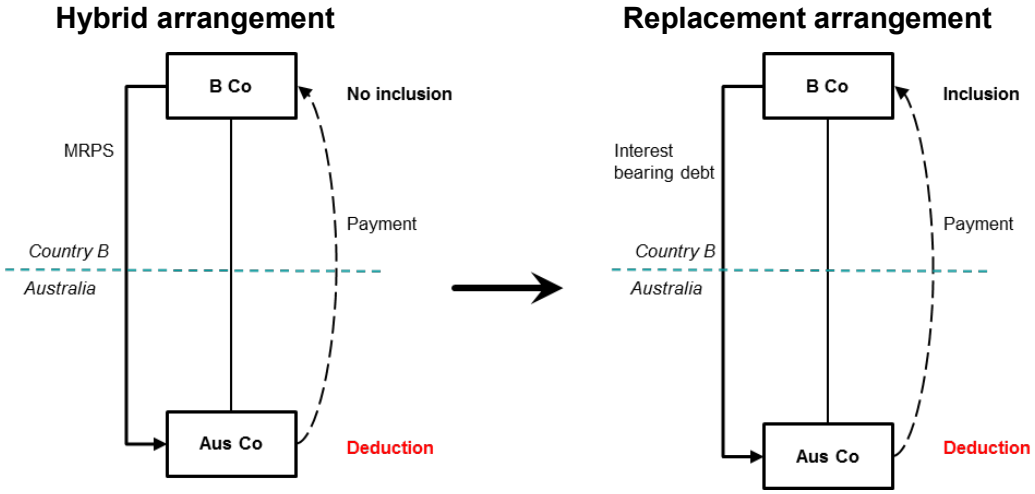
(f) The replacement arrangement is otherwise tax effective. That is, disregarding the potential application of Part IVA of the ITAA 1936, the replacement arrangement preserves a tax benefit. Whether a tax benefit actually exists under a replacement arrangement depends on whether an amount remains deductible or non-included, and is outside the scope of this draft Guideline. For example, in relation to the scenarios described below, whether the borrowing costs are deductible under provisions such as section 8-1 or section 25-90 of the ITAA 1997 is outside the scope of this draft Guideline.

17. The presence of features that are inconsistent with the above may indicate a higher compliance risk. Refer, for example, to the higher risk scenarios in this draft Guideline. It is not, however, the intention of this draft Guideline to prescribe technical advice on the full range of factors that could more heavily point towards the application of Part IVA of the ITAA 1936. This would need to be determined on the facts and circumstances of each case.

[4] Such an assumption may be based, for example, on comments by Hill J in *CPH Property Pty Ltd & Ors v. FC of T* 98 ATC 4983 at p5000.

18. In each of the following scenarios, it is assumed that the counterparty jurisdiction (Country B) has not implemented its own version of the hybrid mismatch rules. In addition, the scenarios do not consider or discuss the impact of other provisions of the tax law which may also have application (for example, the thin capitalisation rules, withholding tax rules).

Scenario 1.1 – inbound mandatorily redeemable preference shares



19. B Co is a company and a tax resident of Country B. Aus Co is a wholly-owned subsidiary of B Co and a tax resident of Australia.

Hybrid arrangement

20. Under an existing arrangement, Aus Co has issued mandatorily redeemable preference shares (MRPS) to B Co. The funds raised through the MRPS are used to expand Aus Co's business operations in Australia.

21. Based on the terms of the MRPS, it is a hybrid financial instrument which gives rise to the following hybrid (D/NI) outcome:

- Aus Co treats the MRPS as a debt interest for the purposes of Division 974 of the ITAA 1997 and is entitled to a deduction for interest payments made to B Co under the MRPS, and
- B Co treats the return it receives from Aus Co on the MRPS as exempt dividends under Country B's tax law.

22. In the absence of Australia's hybrid mismatch rules, this outcome would have been expected to continue for the remaining term of the MRPS.

Replacement arrangement

23. Aus Co and B Co decide to refinance the MRPS to neutralise the hybrid (D/NI) outcome and take the necessary steps to replace the MRPS with an ordinary interest bearing shareholder's loan.

24. Under the replacement arrangement:

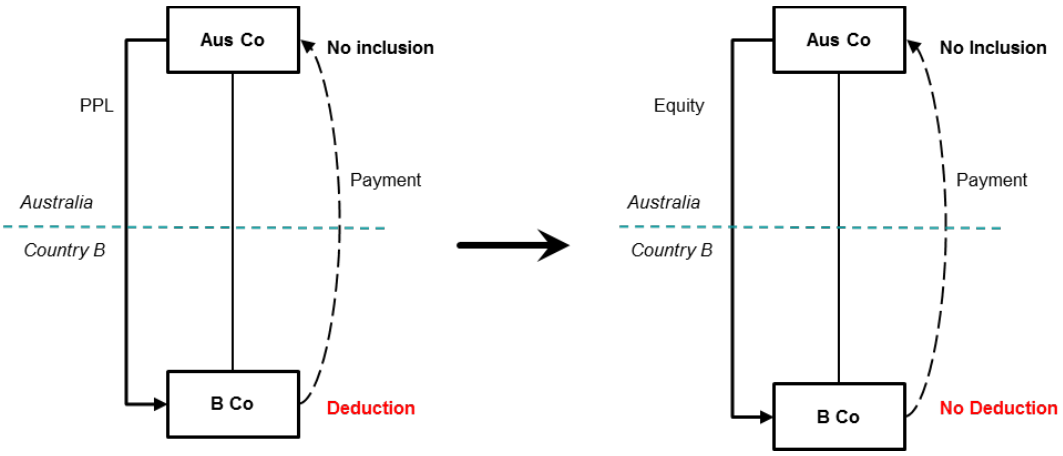
- Aus Co would treat the replacement loan as a debt interest for the purposes of Division 974 of the ITAA 1997 and will be entitled to a deduction in Australia for interest on the loan from B Co, and

- B Co will include the interest on the loan to Aus Co as ordinary income under Country B's tax law.

25. Notwithstanding Aus Co's entitlement to deductions for the servicing costs of the funds received from B Co has been preserved in Australia under the replacement arrangement, the D/NI outcome has been neutralised by the inclusion of the interest income in Country B's tax base.

Scenario 1.2 – outbound profit participating loan

Hybrid arrangement **Replacement arrangement**



26. Aus Co is a tax resident of Australia and wholly owns B Co, a tax resident of Country B.

Hybrid arrangement

27. Under an existing arrangement, Aus Co provides funding to B Co in the form of a profit participating loan (PPL).

28. Based on its terms, the PPL is a hybrid financial instrument giving rise to the following hybrid (D/NI) outcome:

- B Co treats the PPL as debt and is entitled to a deduction for interest payments to Aus Co under Country B's tax law, and
- Aus Co treats the PPL as a non-share equity interest for the purposes of Division 974 of the ITAA 1997 and as a result amounts it receives from B Co under the PPL qualify as non-assessable non-exempt income under Subdivision 768-A of the ITAA 1997.

29. In the absence of Australia's hybrid mismatch rules, this outcome would have been expected to continue for the remaining term of the PPL.

Replacement arrangement

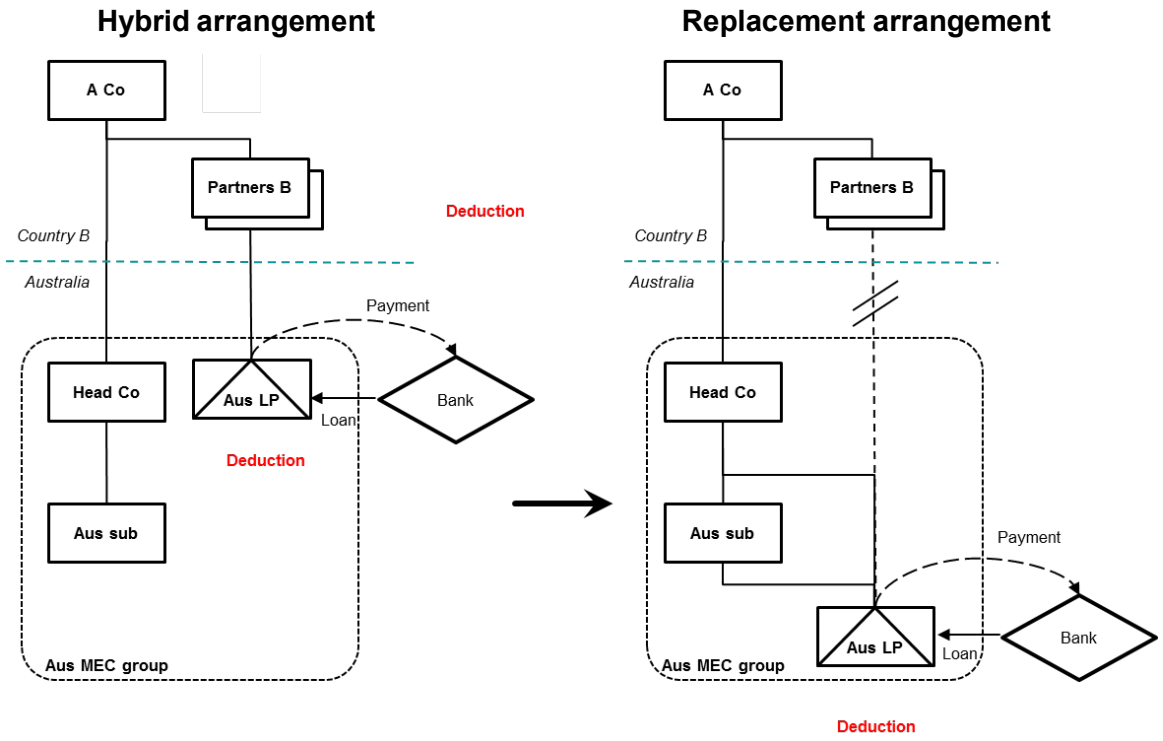
30. Aus Co and B Co decide to refinance the PPL to neutralise the hybrid (D/NI) outcome and take the necessary steps to replace the PPL with ordinary equity.

31. Under the replacement arrangement:

- B Co would not be entitled to a tax deduction in Country B on the payments made to Aus Co, and
- Aus Co would treat dividends received from B Co as non-assessable non-exempt income in Australia under Subdivision 768-A of the ITAA 1997.

32. Notwithstanding Aus Co's entitlement to treat amounts received from B Co as non-assessable non-exempt income has been preserved in Australia under the replacement arrangement, the D/NI outcome has been neutralised by the elimination of an interest deduction from Country B's tax base.

Scenario 1.3 – inbound Australian limited partnership



33. Australian Limited Partnership (Aus LP), Head Co and Aus Sub are all members of an Australian multiple entry consolidated group (Aus MEC Group) and tax resident in Australia. The Aus LP is an eligible Tier-1 company and Head Co is the provisional head company of the Aus MEC Group.

34. The partners of the Aus LP are tax residents of Country B and Aus LP has an existing loan with a third party bank.

Hybrid arrangement

35. For Australian tax purposes, the Aus LP is viewed as a company, but is also treated as part of the Head Co Aus MEC Group by virtue of the single entity rule.[5]

36. Under the tax law of Country B, Aus LP is treated as a transparent entity.

37. Aus LP is a hybrid entity and interest on its bank loan gives rise to the following hybrid (DD) outcome:

- the Aus LP partners are entitled to a deduction in respect of their share of the interest on the loan under Country B's tax law, and

[5] Section 701-1 of the ITAA 1997

- Head Co of the Aus MEC Group is entitled to a deduction in Australia for the interest on the loan.

38. In the absence of Australia's hybrid mismatch rules, it is reasonable to expect that this outcome would have continued for the remaining term of the bank loan.

Replacement arrangement

39. In order to neutralise the hybrid (DD) outcome, a decision is made to undertake an internal reorganisation of the group. Steps are taken to replace the Aus LP's existing partners in Country B (for instance through equity contribution of the Aus LP interests) with Australian resident partners, being the existing members of the Aus MEC (Group Head Co and Aus Sub).

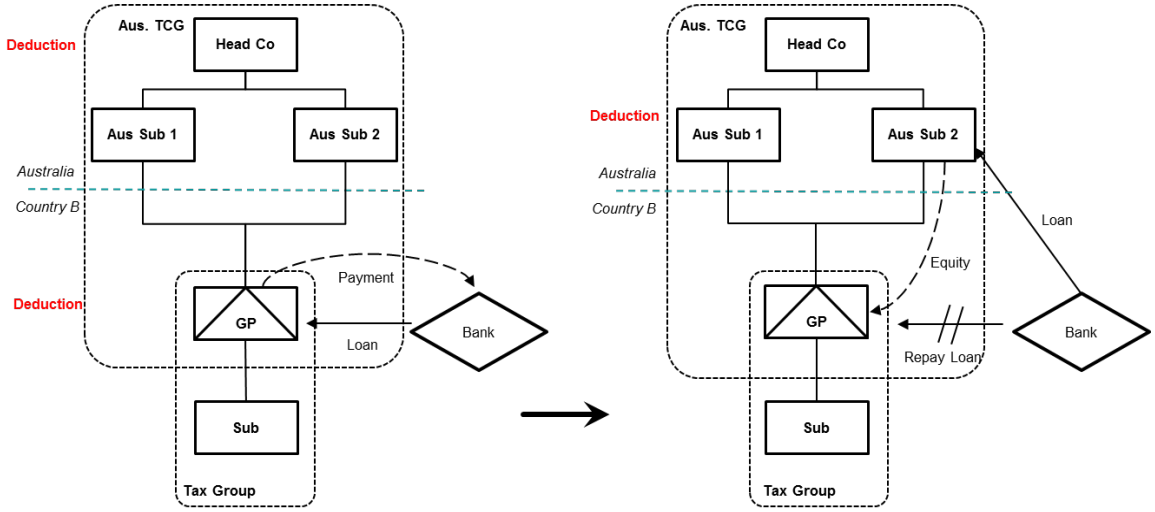
40. Under the replacement structure:

- Head Co will continue to be entitled to a deduction for interest on the bank loan owed by Aus LP, and
- a deduction for interest will no longer be available in Country B.

41. Notwithstanding Head Co's entitlement to interest deductions in Australia on the bank loan continues under the replacement structure, the DD outcome has been neutralised by the elimination of the deduction in Country B.

Scenario 1.4 – outbound general partnership

Hybrid arrangement **Replacement arrangement**



42. Head Co, Aus Sub 1 and Aus Sub 2 are members of the same Australian tax consolidated group (Aus TCG). Aus Sub 1 and Aus Sub 2 hold a partnership interest in a general partnership (GP), which is formed under the laws of Country B.

43. GP has an existing loan with a third party bank.

Hybrid arrangement

44. The GP is viewed as a transparent (flow through) entity for Australian tax purposes, but as an opaque (taxable) entity under Country B's tax law.

45. GP is a hybrid entity and interest payments made by GP on the bank loan give rise to a DD outcome as both the GP and Head Co are entitled to deductions for the interest on the bank loan in Country B and Australia respectively.

Replacement arrangement

46. In order to neutralise the hybrid (DD) outcome, it is decided that GP will repay the existing bank loan in full using equity funding from Aus Sub 2 which, in turn, will enter into a new replacement loan with the bank.

47. Under the replacement arrangement, Head Co will continue to be entitled to a deduction in Australia for interest on the bank loan, but no such entitlement would arise under the replacement structure in Country B. Accordingly the hybrid (DD) outcome will have been neutralised.

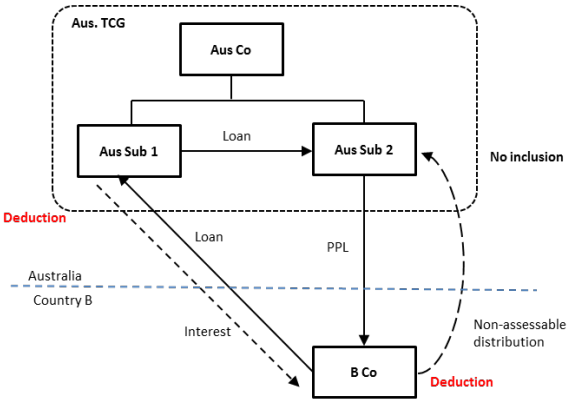
Higher risk scenarios

48. The following scenarios are considered higher risk from a compliance perspective, notwithstanding that the restructure may have removed the hybrid element of the particular arrangement.

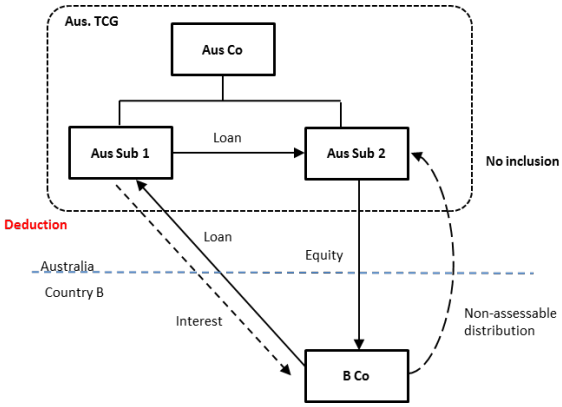
Scenario 2.1 – cross-border round robin financing arrangement

49. This example contains features similar to arrangements described in Taxpayer Alert TA 2016/10 Cross-*Border Round Robin Financing Arrangements*.

Hybrid arrangement



Replacement arrangement



50. Aus Co is the head company of an Australian tax consolidated group (Aus TCG).

51. B Co is a subsidiary resident in Country B. B Co has accumulated tax losses from its operations which are available to carry forward in Country B to offset against future amounts of taxable income.

Hybrid arrangement

52. Under an existing arrangement, Aus Sub 2 provides funding to B Co in the form of a PPL.

53. Based on its terms, the PPL is a hybrid financial instrument giving rise to the following hybrid (D/NI) outcome:

- B Co treats the PPL as debt and is entitled to a deduction for interest payments to Aus Co under Country B's tax law, and

- Aus Co (as head company) treats the PPL as a non-share equity interest for the purposes of Division 974 of the ITAA 1997 and as a result distributions received from B Co under the PPL qualify as non-assessable non-exempt income under Subdivision 768-A of the ITAA 1997.

54. There are similarities in this arrangement to Scenario 1.2 with respect to the PPL. However, assume under this example that the PPL is part of a broader scheme under which B Co has also subsequently provided an interest bearing loan to Aus Sub 1, another subsidiary member of Aus Consolidated Group. Under this scheme:

- Aus Co claims interest deductions in Australia on the borrowing from B Co under section 8-1 or section 25-90 of the ITAA 1997, and
- B Co offsets interest income from Aus Sub 1 against the deduction it claims for the interest payments under the PPL under Country B's tax law, resulting in no tax paid in Country B.

Replacement arrangement

55. Aus Co and B Co decide to refinance the PPL to neutralise the hybrid (D/NI) outcome and take the necessary steps to replace the PPL with ordinary equity.

56. Under the replacement arrangement:

- B Co would no longer be entitled to a tax deduction in Country B on the payments made to Aus Co, and
- Aus Co would continue to treat dividends received from B Co as non-assessable non-exempt income in Australia under Subdivision 768-A of the ITAA 1997.

57. It can be observed that the refinance of the PPL to ordinary equity in this example is effectively the same restructure as outlined under Scenario 2. However, under the broader scheme:

- Aus Co continues to claim interest deductions in Australia on the borrowing from B Co under section 8-1 or section 25-90 of the ITAA 1997, and
- B Co subsequently offsets interest income from Aus Sub 1 against its carried forward tax losses resulting in no tax paid in Country B.

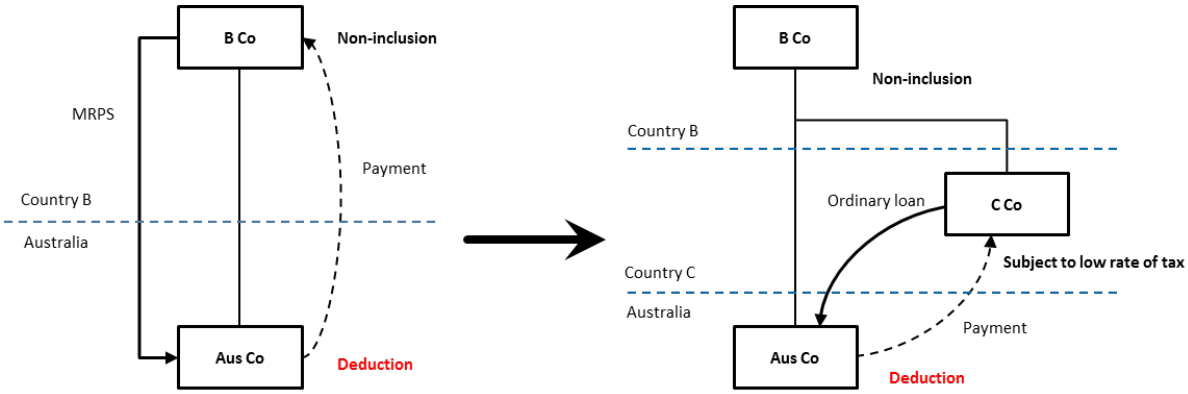
58. In substance, the replacement arrangement continues to achieve similar outcomes to the original arrangement, both of which contain features of the types of cross-border round robin financing arrangements described in TA 2016/10.

59. In this example, notwithstanding that the hybrid element has been removed under the restructure, the arrangement would be considered a higher risk from a compliance perspective.

Scenario 2.2 – conduit financing via a low tax jurisdiction

60. The replacement arrangement in this example is an alternative to the replacement arrangement in the low risk example described in Scenario 1.1. It involves the interposition of a third company, C Co, which is resident in a low tax jurisdiction.

Hybrid arrangement **Replacement arrangement**



61. B Co is a company and a tax resident of Country B. Aus Co is a wholly-owned subsidiary of B Co and a tax resident of Australia. C Co is another wholly-owned subsidiary of B Co and a tax resident of Country C. Country C has a substantially lower rate of corporate tax as compared to Country B and Australia.

Hybrid arrangement

62. As with Scenario 1.1, the MRPS is a hybrid financial instrument that gives rise to a D/NI outcome which, in the absence of Australia's hybrid mismatch rules, would have been expected to continue for the remaining term of the MRPS.

Replacement arrangement

63. Unlike Scenario 1.1, the replacement arrangement interposes C Co as the direct lender to Aus Co. The replacement arrangement involves the following steps:

- Aus Co redeems the MRPS
- B Co uses the proceeds from the redemption of the RPS to equity capitalise C Co
- C Co uses the funds received from B Co to lend to Aus Co pursuant to an ordinary interest bearing shareholder's loan.

64. Under the replacement arrangement:

- Aus Co would treat the replacement loan as a debt interest and, disregarding the potential application of the integrity rule in Subdivision 832-J of the ITAA 1997[6], would be entitled to a deduction in Australia for the interest on the loan from C Co
- the interest payment received by C Co is subject to tax at a substantially lower rate of tax than if the lender had been B Co, and
- Country B does not require that B Co include the interest income received by C Co in its tax base on an accruals basis (for example, under a controlled foreign company regime) and as a result the interest payment is not subject to tax in Country B. Any dividends paid by C Co to B Co are exempt from tax in Country B under a dividend participation exemption.

[6] This is based on the assumption that Subdivision 832-J of the ITAA 1997 as it appears in *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018* passes into law.

65. In this example, the restructuring is not straightforward and goes further than merely removing the hybrid element of the existing arrangement. In particular it does not accord with one of the assumptions outlined in paragraph 16 of this draft Guideline that there is no change under the replacement arrangement to the jurisdictions of the entities involved in the hybrid arrangement. Accordingly, the arrangement would be considered a higher risk from a compliance perspective.

66. The application of the integrity rule in Subdivision 832-J of the ITAA 1997[7] to this scenario would also need to be considered, but is outside the scope of this draft Guideline.

Early engagement and reporting your risk assessment

67. If you are considering restructuring in a way that is not covered by the low risk scenarios in this draft Guideline and would like to mitigate your compliance risk or if you would like to obtain a greater level of certainty, we encourage you to engage with us about your proposed restructure. Further information will be published on our website to assist your engagement with us.

68. You can also send any general enquiries to us at: HybridMismatches@ato.gov.au

69. You may be required to disclose information about your arrangements or any restructures in the Reportable tax position (RTP) schedule.

Commissioner of Taxation
21 June 2018

[7] This is based on the assumption that Subdivision 832-J of the ITAA 1997 as it appears in *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018* passes into law.

Your comments

70. You are invited to comment on this draft Guideline including the proposed date of effect. Please forward your comments to the contact officer by the due date or join the conversation on this draft Guideline on the Public Advice and Guidance Community on Let's Talk.

71. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments
- may be published on the ATO website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **20 July 2018**

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

References

ATOlaw topic(s)	Tax integrity measures ~~ Part IVA ~~ General anti-avoidance rules
Legislative references	ITAA 1936 ITAA 1936 Pt IVA ITAA 1936 177D(2) ITAA 1997 ITAA 1997 8–1 ITAA 1997 25–90 ITAA 1997 701–1 ITAA 1997 Subdiv 768–A ITAA 1997 Div 832 ITAA 1997 Subdiv 832–J ITAA 1997 Div 974
Case references	Federal Commissioner of Taxation v Hart (2004) 217 CLR 216 CPH Property Pty Ltd & Ors v Commissioner of Taxation 98 ATC 4983 CPH Property Pty Ltd & Ors v. FC of T 98 ATC 4983
Other references	Taxpayer Alert TA 2016/10
ATO references	1-EZCGEL0
BSL	PGI