12 April 2019

Global Tax Alert

Australian Taxation Office releases Draft Law Companion Ruling on targeted integrity rule under the hybrid mismatch rules

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

On 5 April 2019, the Australian Taxation Office (ATO) released Draft Law Companion Ruling LCR 2019/D1 *OECD hybrid mismatch rules – targeted integrity rule* (draft ruling).

The draft ruling addresses the ATO's views on specific aspects of the targeted integrity rule in Australia's hybrid mismatch rules. The targeted integrity rule affects financing structures whereby an entity (the interposed foreign entity) in a low (10% or less tax rate) or no tax jurisdiction is interposed as lender between the foreign parent (the ultimate parent entity or UPE) and the Australian borrower. Where the integrity rule applies, deductions for interest payments on the relevant financing arrangement should be disallowed.

While the integrity rule was introduced to target financing structures which otherwise circumvent more "traditional" hybrid structures, this rule has more wide-ranging implications for taxpayers as it applies to any financing through low/no tax jurisdictions regardless of whether these were implemented in anticipation of the hybrid mismatch rules.

The specific aspects explored in the draft ruling are:

Ultimate parent entity: To identify the UPE for the purposes of the integrity rule, there is a requirement that this entity is not controlled by another member of the Division 832 control group. The draft ruling provides some clarification

Building a better working world

by way of an example. Identification of the UPE is important having regard to the exclusion from the integrity rule where the UPE itself is subject to a low tax rate/no taxed in its jurisdiction.

Subject to foreign income tax: The draft ruling clarifies when a payment may be considered "subject to foreign income tax." This concept has wider application than the integrity rule given that the definition of "deduction/non-inclusion mismatch" (a gateway provision to the hybrid mismatch) and "dual inclusion income" also require an amount to be "subject to foreign income tax."

It should also be noted that the 2019/2020 Budget announcement included a technical amendment to limit the meaning of foreign income tax for the purposes of the hybrid mismatch rules. Although no further detail was provided, we expect the amendments will clarify whether state or local taxes are considered to be foreign income tax for such purposes.

Matters to be considered in relation to the principal purpose test:

1. **Facts and circumstances in relation to the scheme** include consideration of the circumstances surrounding the establishment of the interposed entity and how it fits into the overall structure. The ATO considers it may, for example, be a mitigating factor where interests in the interposed foreign entity are held by entities outside of the Division 832 control group.
2. **Source of funds**: The analysis of the source of funds used by the interposed foreign entity to lend to the Australian entity involves consideration of the relevant cash flows, servicing costs and associated tax treatment in the jurisdictions of the entities involved. In particular, this requires consideration of whether there is effectively a conversion of a taxable interest payment to a non-taxable return as a result of funds being routed via the interposed foreign entity.
3. **Substantial commercial activities in carrying on a banking, financial or other similar business**: In the ATO's view, this matter requires an analysis of the assets, functions and risks of the interposed foreign entity to conclude if the entity is engaged in a banking, financial or other similar business. This again looks at the relevant entity engaging in both lending and borrowing activities, as well as pooling of funds, risk management activities, etc. No further definition of what would constitute a "banking, financial or other similar business" is provided in LCR 2019/D1. However, examples 3 and 4 in the draft ruling highlight activities which point towards whether the requisite business is being carried on.

Back-to-back arrangements: Where back-to-back funding is provided, the integrity rule analysis should be applied to the ultimate rather than the immediate lender. The draft ruling provides that where entities are part of a fiscal unity, consolidated group, or otherwise subject to group relief, ordinary equity interests in the funding chain may not stop the back-to-back rule from operating. Otherwise, the draft ruling contains only limited guidance on what may be considered a back-to-back arrangement including when arrangements may have substantially the same terms.

Implications

While the draft ruling does not contain a lot of surprises (and leaves certain questions unanswered), it does provide further insight as to how the ATO may seek to apply the principal purpose test. In particular, in the context of groups with an established treasury/group financing function in a low/no tax jurisdiction, even if the treasury entity has a lot of lending activities and employees carrying on these activities, this may be insufficient to show that the principal purpose test is not met where the entity is not also borrowing or it cannot be shown that the interest income received by the treasury entity is ultimately taxed elsewhere.

It is notable that the timing of the release of the draft ruling coincides with the 2019/2020 Budget announcement that the integrity rule will be amended to be considered in conjunction with other hybrid mismatch rules. Previously, if a payment gave rise to another hybrid mismatch, the integrity rule could not also apply. There is a concern the integrity rule could now apply to taxpayers with hybrid mismatches that would otherwise be sheltered due to the existence of Dual Inclusion Income. Inbound multinationals from the United States (US) for example will need to consider whether the effect of checking entities to be disregarded for US tax purposes may expose them to the integrity rule. Legislation to give effect to the budget announcement will not be released by Treasury until after the election which will be held on 18 May 2019.

Submissions in relation to draft ruling are due by 10 May 2019. The final guidance is proposed to be effective from 1 January 2019.

For additional information with respect to this Alert, please contact the following:

Ernst & Young (Australia), Sydney
- Sean Monahan sean.monahan@au.ey.com
- Stephen Chubb stephen.chubb@au.ey.com
- Lachlan Cobon lachlan.cobon@au.ey.com

Ernst & Young (Australia), Melbourne
- Brendan Dardis brendan.dardis@au.ey.com
- Peter Janetzki peter.janetzki@au.ey.com

Ernst & Young (Australia), Perth
- Andrew Nelson andrew.nelson@au.ey.com
- David S Browne david.browne@au.ey.com

Ernst & Young LLP (United States), Australian Tax Desk, New York
- David Burns david.burns1@ey.com

Ernst & Young LLP (United Kingdom), Australian Tax Desk, London
- Naomi Ross naomi.ross@uk.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 001770-19Gbl

1508-1600216 NY
ED None

ey.com