KPMG Submission

Exposure Draft

Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017

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Executive Summary

We welcome the release of the Exposure Draft of *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017.*

Key recommendations are as follows:

Recommendation 1:	The commencement date should be on the first day of a quarter. Preferably this would be the first date which is 6 months after Royal Assent, but if this is perceived to give rise to undue delay, it could be the first day of a quarter closest to six months after Royal Assent.
Recommendation 2:	There should be appropriate consultation for any anti-hybrid supportive anti-avoidance provision, even if this means that the Bill for such a provision is introduced later in the year, but with a start date being the same as the main anti-hybrid provisions.
Recommendation 3:	Delay the operation of the imported mismatch rule to 1 January 2020 for all hybrid transactions, to coincide with the introduction of substantially all the EU rules. This could be undertaken in conjunction with a rule in the specific anti-avoidance provisions designed to attack transactions put in place to subvert the operation of the anti-hybrid rules.
Recommendation 4:	A commencement rule based on deductions, rather than payments, should be adopted.
Recommendation 5:	Paragraph 832-795(3)(b) provides a deeming rule in relation to the concept of an “indirect” nexus under the imported mismatch rule. Broadly, it says that there is sufficient nexus if payments exist between each interposed entity that give rise to a (foreign income tax) deduction. A management fee could thus provide nexus to a financing transaction. We believe that is too broad and should be removed, leaving the general concept of an indirect relationship to operate and for the EM to make it clear that such payments are not covered.
Recommendation 6:	On one reading the imported mismatch rule appears to operate such that a deduction is denied for un-negated residual amounts, rather than for an appropriate share allocated to Australia. The wording should be reviewed to ensure that this is not the case.
Recommendation 7:	The concept of a “corresponding” anti-hybrid provision in the foreign jurisdiction is central to how the anti-hybrid rules operate. A question arises as to what happens where there is a partial application of “our” rules or the Action 2 recommendations. This should be addressed.

Recommendation 8:	There is a specific question in relation to US Dual Consolidation Loss rules. As a broad principle, where the US Dual Consolidation Loss rules operate in such a manner that they have a *similar ultimate effect* in denying tax benefits as would conventional Action 2 hybrid mismatch rules, then the Dual Consolidation Loss rules consideration should be given to considering the DCL rules to be “corresponding” rules for the purposes of our provisions.
Recommendation 9:	It is appropriate that the anti-hybrid rules do not provide for special measures dealing with FX, where normal translation rules would apply to determine amounts of interest denominated in a foreign currency for example.
Recommendation 10:	The current concept of a financial instrument in the Exposure Draft has the benefit of simplicity. Consideration should be given to whether the concept should be linked to the IFRS definition. (We are looking into the pros and cons of such a linkage with a view to reverting to you in due course.)
Recommendation 11:	The transitional provisions that apply to authorized deposit taking institutions on AT1 capital should extend to regulated general insurers and their Authorised Non-Operating Holding Companies.
Recommendation 12:	The Exposure Draft refers to an “available call” date which occurs after 9 May 2017. We recommend that this is modified to a “scheduled call” date which minimizes the uncertainty in circumstances where a “Tax Event” can trigger a call.
Recommendation 13:	In the Board of Taxation Report on Regulatory Capital it is stated that if Section 215-10 is to be retained then “… further consideration should be given to amending the section to make it more workable in practice, and to extend its useability by … extending its application to regulated insurance entities.” (See B.19). Consideration should be given to providing an extension in Section 215-10 to regulated insurance entities in this legislative package.

Our detailed observations are set out below.

Detailed Comments

1. General

1.1. KPMG welcomes the opportunity to comment on the Exposure Draft of *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2017* (Exposure Draft) and associated Exposure Draft Explanatory Memorandum (EDEM) as published by Treasury on 24 November 2017.

2. Commencement date

2.1. **General factors.** The Board of Tax report, with which the Government agreed, suggested that the commencement date should be the later of 1 January 2018 or 6 months after Royal Assent. Since that time three points have arisen. First, it has been considered desirable that commencement take place on the first day of a quarter. Second, it is desirable that any anti-avoidance provisions that seek to ensure that structures are not put in place to subvert the intent of the anti-hybrid rules should commence at the same time as the anti-hybrid rules. Such rules are likely to be complex and require detailed consideration. Third, it is acknowledged that community and political concern is such that the introduction of the anti-hybrid rules should not be unduly delayed. We acknowledge all three points.

2.2. **Balancing concerns.** In balancing the above three concerns, we submit the following:

(i) It is critical that there is adequate consultation for any anti-hybrid supportive anti-avoidance provision, even if this means that the Bill for such a provision is introduced later in the year, but with a start date being the same as the main anti-hybrid provisions;

(ii) The suggestion that the anti-hybrid rules commence on the first day of a quarter is a very good one due to the simplicity it offers in communicating changes globally;

(iii) It would be desirable for the original 6 month Board of Tax rule to be honoured. However, given the importance of the principle in (ii), it may be preferable to have a commencement date being the first quarter closest to 6 months after Royal Assent.

2.3. **Imported mismatch rule.** There is an exception to the above proposition which concerns the imported mismatch rule. We believe there is substantial merit in delaying its commencement date until 1 January 2020 when, broadly, 27 EU countries have agreed to introduce anti-hybrid rules. There are four main options for a modified commencement rule. They are:

Option 1: Delay the operation of the imported mismatch rule to completely match the EU rules. Thus an imported mismatch for most hybrids would apply from 1 January 2020, but the operation of an imported mismatch rule for reverse hybrids would be delayed until 1 January 2022 (to match the EU introduction). This could be undertaken in conjunction with a rule in the specific anti-avoidance provisions designed to attack transactions put in place to subvert the operation of the anti-hybrid rules;

Option 2: Delay the operation of the imported mismatch rule to 1 January 2020 for all hybrid transactions to coincide with the introduction of substantially all the EU rules. This could be undertaken in conjunction with a rule in the specific anti-avoidance provisions designed to attack transactions put in place to subvert the operation of the anti-hybrid rules;

Option 3: Delay the operation of the imported mismatch rule for all control group transactions under the principles of either (i) or (ii), but not for structured arrangements commencing after the date of introduction of the Bill;

Option 4: Delay the operation of the imported mismatch rule for all control group arrangements under the principles in (i) or (ii), but not for structured arrangements entered into at any time.

2.4. **Preference for Option 2.** The essential reason for delaying the operation of the imported mismatch rule is that in the absence of such a delay, considerable focus and resources – by the ATO and MNEs - will be devoted to determining whether or not there are up-chain non-negated hybrids that could give rise to the denial of deductions in Australia. This focus has a slightly capricious element to it, and will not be without reputational damage, given that many MNEs will think they have until 2020 to unwind their EU hybrid structures. The preference for Option 2 over the other options is grounded in simplicity. Delineating between a structured arrangement and one

that is merely a control group arrangement will not be easy and will largely be unnecessary under Option 2. The Revenue is protected from egregious planning by the potential operation of a specific anti-avoidance rule.

2.5. **Payment vs deduction**. Whilst there are pros and cons of adopting a payment vs a deduction rule for the commencement rule, a deduction rule is preferable as it is less likely to invite planning around the rule and simply accords better with the underlying principles of the anti-hybrid rules.

3. Imported mismatch rule nexus

3.1. Section 832-795 provides the meaning of importing payment. Broadly it seeks to set up a nexus between a deductible payment by an Australian entity and an offshore hybrid mismatch. If the relationship is direct the operation of the provision is clear. There is a question concerning whether there is an "indirect" relationship between payments. Paragraph 832-795(3)(b) effectively provides a deeming rule, by saying that it is sufficient if payments exist between each interposed entity that give rise to a (foreign income tax) deduction. We believe that is too broad.

3.2. A MNE is often a highly complex organization. There can be substantial deductible payments and assessable amounts within a group amongst a substantial number of companies. If the operation of the rule merely requires – as it would seem to – that any trace of deductible payments can be found from Australia to an entity with an un-negated hybrid – however remote from, or unrelated to hybrid planning the payments may be (eg. a management fee in relation to a financing arrangement), then the provision will be both very complex to administer and have unintended and potentially severe consequences.

3.3. Section 832-795(3)(a) provides that it is not necessary to demonstrate that each payment in a series of payments funds the next payment, or is made after the previous payment. Paragraphs 256 and 257 of the OECD report note that the indirect imported mismatch rule applies both a tracing and an allocation methodology and that the group

member's surplus hybrid deductions are allocated proportionately around the group in accordance with taxable payment flows within the group and *in a way that takes into account the extent to which such taxable payments have been funded, directly or indirectly out of imported mismatch payments*. The concept of "funded taxable payments" is also picked in paragraph 259 and in the examples and flow diagrams in the OECD report. The indirect imported mismatch examples in the OECD proposal use the relatively simple examples of a hybrid financing instrument and downstream indirect loan transactions and so do not provide much further guidance on how far the concept of funded taxable payments stretch (and to what extent a non-financing payment can be viewed as "funding" another type of payment, particularly where there may be a complex mix of different types intra-group payments in both directions throughout a MNE group).

3.4. Our preference would be to leave the nexus simply based on the word 'indirectly', rather than to deem any mathematical combination of payments to fit within the concept of an indirect payment and to remove the express reference that the payments are not required to fund the next payment. This would appear to be more consistent with the OECD proposals.

4. Imported mismatch rule

4.1. The imported mismatch rule appears to operate such that a deduction is denied for un-negated residual amounts rather than for an appropriate share allocated to Australia. The definition of "remaining offshore hybrid mismatch" in section 832-805 could be read as allowing a foreign jurisdiction with hybrid mismatch rules to have priority in neutralizing an imported mismatch of equal priority (structured arrangement, direct payment or indirect payment), as it does not link back to the OECD report to determine the allocation. Rather, Australia appears to be left with any residual amount not neutralized by another country (which would rely on those other countries' hybrid mismatch rules to link back to or replicate the OECD report imported mismatch allocation methodology to provide a fair allocation to Australia).

5. Foreign hybrid mismatch rules – definition of corresponding

5.1. A fundamental feature of the hybrid mismatch rules is that they have regard to what happens in another jurisdiction. Indeed the drafting refers to “corresponding” rules to our own. The question arises as to what happens where there is a partial application of “our” rules or the Action 2 recommendations. This may well be the case in relation to Reverse Hybrids in the EU, between 2020 and 2022, for example.

5.2. There is a specific question in relation to US Dual Consolidation Loss rules. As a broad principle, where the US Dual Consolidation Loss rules operate in such a manner that they have a *similar ultimate effect* in denying tax benefits to the conventional Action 2 hybrid mismatch rules, then consideration should be given to the question of whether the US Dual Consolidation Loss rules should be considered to be “corresponding” rules for the purposes of our provisions. This is a complex issue.

5.3. Ultimately most would agree that the purpose of the hybrids rules is to achieve a result that makes economic sense when viewed on a global basis. The question then arises as to how widely or narrowly ones purview in asking the question of what makes economic sense. The Exposure Draft and associated press release, not inappropriately, takes a wider view than the basic question concerning income and deductions. It does this in three ways – it considers the position on foreign tax credits, franking credits and, in embracing an anti-avoidance provision, the position of alternative structures that achieve a similar result. In some sense, these measures go beyond the Action 2 Report.

5.4. If our hybrid rules were to treat the US Dual Consolidation Loss provisions as a corresponding provision it would be extending the purview even further in addressing the question of what is the correct economic result. This is because such an extension would address the question of whether there is a true double dip or not even though there are double deductions. The US Dual Consolidation Loss rules deny a double dip by quarantining losses such that they cannot be

used by wider group companies. There is a complex exception to the rule which effectively allows a double dip where the utilisation of a loss in two jurisdictions is more than 5 years apart. Leaving that exception aside (which could be specifically dealt with), embracing the US Dual Consolidation Loss rules as a corresponding provision achieves the right economic result when considering the utilisation of losses.

5.5. In saying this it should be recognised that the Dual Consolidation Loss rules have a different architecture to the hybrid rules. They also deal with branches which we have not considered.

5.6. If you would like to discuss this with our US experts in Washington National Tax to gain a greater understanding of the US rules, we would be happy to facilitate that.

6. Foreign exchange differences

6.1. The Exposure Draft, in one sense, does not deal with foreign exchange differences. That is it does not provide for special rules dealing with FX. We believe this is appropriate and simple. That said, normal translation rules would apply to determine amounts of interest denominated in a foreign currency for example.

7. Financial instrument definition

7.1. The current of concept of a financial instrument in the Exposure Draft has the benefit of simplicity. There is a question of whether the concept should be linked to the IFRS definition. We are looking into the pros and cons of such a linkage with a view to reverting to you in due course.

8. Application of AT1 provisions to general insurers

8.1 It is our understanding that at least one general insurer has issued AT1 instruments as part of its capital structure. The transitional provisions that apply to authorized deposit taking institutions should extend to regulated general insurers and their Authorised Non-Operating Holding Companies.

8.2 Further, the Exposure Draft refers to an "available call" date which occurs after 9 May 2017. We understand that it would be preferable if this was modified to a "scheduled call" date. The reason for this is that an available call date could potentially refer to a call right triggered by a "Tax Event" thereby leading to investor uncertainty and the potential acceleration of the application of the measure.

8.3 In the Board of Taxation Report on Regulatory Capital it is stated that if Section 215-10 is to be retained then *"… further consideration should be given to amending the section to make it more workable in practice, and to extend its usability by … extending its application to regulated insurance entities."* (See B.19). Consideration should be given to providing an extension in Section 215-10 to regulated insurance entities in this legislative package.