THE TAX INSTITUTE

THE MARK OF EXPERTISE

22 December 2015

Ms Karen Payne
Chair
Anti-hybrids Board of Taxation Working Group
c/- The Treasury
Langton Crescent
PARKES ACT 2600

By email: hybrids@taxboard.gov.au

Dear Ms Payne,

Implementation of the OECD Anti-hybrid rules

The Tax Institute welcomes the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the *Implementation of the OECD Anti-hybrid Rules Consultation Paper* (**Consultation Paper**).

From the initial consultation with the Board held in Sydney and Melbourne on 24 and 27 November respectively, The Tax Institute understands it is the Government's policy to implement the recommendations made in the OECD's report *Neutralising the Effects of Hybrid Mismatch Arrangements, Action Item 2 – 2015 Final Report* (**Action Item 2 Report**). In this regard, The Tax Institute seeks to assist the Board in its task to determine the best way for Australia to implement the recommendations per our submission below.

Summary

In summary, we submit to the Board the following:

- The rules inserting the anti-hybrid regime into Australian tax law should be drafted as tightly as possible and should use the existing apparatus of the law, taking into account their impact on existing commercial arrangements.
- Consideration should be given as to whether rules should be inserted as a separate regime or could be included in Part IVA of the *Income Tax Assessment Act 1936* (Cth). Other 'priority' regimes should be considered when determining the priority operation of these rules.

- The rules should allow for transition and grandfathering to try to limit the impact of implementation of these rules on existing commercial arrangements.
- There is potential for conflicting regimes to be adopted by different countries which could lead to double taxation.
- For those reasons, implementation of these rules in Australia should not be rushed and should be harmonised with other jurisdictions.

Discussion

Question numbers noted below are references to the Question numbers in the Consultation Paper.

1. Overview

As an initial comment, The Tax Institute is of the view that, in implementing the Government's decision, as a first step Australia should implement Recommendations 1 and 2 into its tax law and then take its time to consider how and when the remainder of the recommendations should be implemented.

2. Drafting principles

In the Tax Institute's view, the provisions should be drafted as tightly as possible to provide certainty for taxpayers.

3. Insertion of the anti-hybrid rules into Australian tax law (Q4)

Q4(a)

The anti-hybrid rules are specifically aimed at removing arbitrages created by differences in countries' existing international tax systems, i.e. addressing perceived inappropriate outcomes that continue to exist after application of the entire body of tax law, including anti-avoidance rules. The anti-hybrid rules should therefore operate as a provision of last resort, i.e. only after all other rules, including Part IVA of the *Income Tax Assessment Act 1936* (Cth), have operated. They should be drafted to apply only so far as the relevant objectives are not already achieved by the existing law[1].

We suggest that consideration could also be given to implementing the anti-hybrid within the framework of Part IVA, as was done with the 'multinational anti-avoidance' provisions[2]. This could be accomplished by:

[1] For example, in relation to Question 29 in the Consultation Paper, the recent decision in *Orica Limited v Commissioner of Taxation* [2015] FCA 1399 suggests that the existing provisions of Part IVA can counteract some schemes which comprise both Australian and foreign tax elements).

[2] Refer to *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015* (Cth)

(i) establishing another limb of Part IVA that would be enlivened for hybrid arrangements;

(ii) mandating that particular weight be given in determining purpose to the tax outcome in the other jurisdiction, i.e. to obtain a deduction (or exemption), weight must be given to whether an exemption (or deduction) is available in the other jurisdiction; and

(iii) ensuring that it would not be a defence to cite a tax benefit in another jurisdiction as the purpose of the transaction. As pointed out above, in our view, the rules should not apply unless there is erosion of the Australian tax base. Making the anti-hybrid rule a purpose-based anti-avoidance rule would allow its operation to be appropriately restricted.

If the Board considers that the anti-hybrid rule should not be a provision of last resort, we note that there are a number of sets of rules in the tax law that are said to take priority over other rules. It is becoming more difficult to determine from a statutory interpretation view point how the 'priority' regimes should interact with each other (apart from Part IVA. Further, due to the broad scope of particular provisions (eg the transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**)), it is becoming more difficult to achieve tax policy objectives in particular areas where there is overlap in the area of operation of two or more 'priority' regimes. An additional consequence is an increase in compliance costs for taxpayers.

Before a determination is made as to whether the anti-hybrid rules are to be a (another) regime that takes priority, we suggest a review of the 'priority' regimes be undertaken and recommendations made as to the order in which those regimes should apply (e.g. Division 768-A, Division 974 and Division 815 of the **1997 Act** (Cth)) and then a determination be made as to where the anti-hybrid rules should fit in.

Further, an ordering rule alone may not enable tax policy objectives in particular areas to be achieved where there is overlap in the area of operation of two or more 'priority' regimes. We therefore suggest that the review of priority regimes also consider which 'priority' regime should take precedence in relation to the area of overlap and a determination made as to where the anti-hybrid rules should fit in.

The Tax Institute does not consider that the anti-hybrid rules should act as a characterisation rule, i.e. the definition of debt and equity for Australian tax purposes should not be affected by whether the anti-hybrid rules operate. This is because the effect would otherwise be to subordinate the debt/equity rules to the characterisation rules of other jurisdictions. This would make the Australian tax rules exceedingly difficult to administer.

Nevertheless, where the anti-hybrid rules do apply, care should be taken to ensure that they do not result in outcomes that are worse than would occur under the re-

characterised arrangement. For example, if interest deductions are denied on a hybrid financing arrangement, interest withholding tax should not also be applied, since in ordinary circumstances this would produce a more onerous outcome than paying dividends on common equity. Careful attention will need to be paid to "compensating adjustment" issues relating to, for example, franking.

Q4(c)

Subject to the suggestion above about possibly including the anti-hybrid rules into Part IVA, the rules should otherwise be inserted into the revenue law as a stand-alone set of provisions. However, we recommend that as few new definitions as possible should be introduced and existing definitions in the law for relevant terms should instead be used. For example, the current definitions of 'financial arrangement', 'financial benefit' and, more generally, the apparatus of the debt and equity provisions could be used.

4. Requirement for grandfathering (Q9)

In our view, these rules should apply prospectively from the time of enactment. Existing hybrid arrangements that will be directly impacted by these rules should be grandfathered, particularly arrangements involving third parties. This could be achieved by applying the rules prospectively to related party transactions only in the first instance.

We cannot see how these rules could be introduced without provision being made for grandfathering arrangements without substantial unfairness and damage to Australia's reputation as a safe investment destination.

5. Requirement for transitional rules (Q8)

Sufficient time will be required for taxpayers to transition existing arrangements to any anti-hybrid rules that are introduced. It is likely that complex rules will need to be introduced into Australia's tax law to accommodate (and implement) the OECD's recommendations in the Action Item 2 Report.

Care will need to be taken as to how the introduction of these rules will impact pre-existing arrangements, in particular arrangements involving related parties and third parties.

Arm's length arrangements should be grandfathered. Existing related party arrangements should be given a transition period that reflects the fact that some of financial arrangements impacted will relate to infrastructure projects that will have relatively long lives.

We cannot see how these rules could be introduced without provision being made for transitional arrangements without substantial unfairness and damage to Australia's reputation as a safe investment destination.

6. Appropriate start time for the regime to apply in Australia (Q6 & Q7)

The Tax Institute strongly recommends that Australia remain in step with other OECD countries and only implement the anti-hybrid rules around the same time as the majority of other OECD countries decide to implement the rules.

There is no advantage to Australia being an 'early adopter' of these rules. Ideally the date of introduction of these rules into Australia should be tied to other major trading partners' start dates (such as that for the United States, Japan and other major European Union countries).

7. Compliance costs (Q2)

We strongly recommend the anti-hybrid rules be implemented with minimal compliance cost implications for taxpayers. This could be achieved by mechanisms, such as:

- Appropriate carve outs for low value transactions and small entities should be implemented, where possible in light of the international nature of these rules;
- Use of existing definitions and concepts in the existing legislation so far as possible.

8. Resolving conflicting regimes

We perceive a conflict may arise where one country adopts Recommendation 1 and another country adopts Recommendation 2. Such a situation could result in 'double taxation' arising, which, in our view, would not be an intended outcome of the OECD upon making these recommendations[3].

Ordinarily such potential situations of double taxation are resolved through bilateral treaty negotiations. However, given this situation involves a number of OECD countries, it will be very difficult and onerous to resolve this conflict via bilateral treaty negotiations alone.

We therefore query how the Government may propose to resolve this issue. We suggest the proposed multi-lateral treaty may offer a possible solution and suggest the Government may wish to approach the OECD on this basis. This issue reinforces the

[3] Refer to the discussion in the article Cooper, G. 'Some thoughts on the OECD's Recommendations on Hybrid Mismatches', *Bulletin for International Taxation* (2015) Vol. 69 Issue no. 6/7 at pp334-349, in particular at pp346 - 347.

danger in rushing to implement these rules before other jurisdictions, as set out at item 6 above.

9. Relevance of base erosion outcomes

The Action Item 2 Report does not currently require that any base erosion or profit shifting in fact occurs with respect to the Australian revenue before the anti-hybrid rules operate. The Tax Institute considers that this is a serious deficiency in the recommendations. If the anti-hybrid rules are not limited to activities that are erosive of the Australian revenue, then the rules will by definition be restricting otherwise legitimate business activity.

The Tax Institute considers that safeguards should be included in the anti-hybrid rules so as not to unduly damage economic activity in Australia.

If another jurisdiction is suffering base erosion due to a hybrid transaction, this can only be addressed by the other jurisdiction taking action. If the hybrid transaction is not erosive of the Australian tax base, then increasing the tax burden in Australia will not address the problem. This will simply make Australia less competitive as a jurisdiction and reduce capital flows between Australia and other countries.

10. Insufficient time for appropriate consultation

While we are mindful of the commitment the Government has made to implement the anti-hybrid rules contained in the Action Item 2 Report by tasking the Board with this, we hold the view that the Government has allowed insufficient time for proper consultation and consideration as to how best to implement these rules into the Australian tax system.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Arthur Athanasiou
President - elect