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Board of Taxation Secretariat
C/- The Treasury
Langdon Crescent
Parkes, ACT 2600

hybrids@taxboard.gov.au

Implementation of the OECD anti-hybrid rules

The Corporate Tax Association (CTA) welcomes the opportunity to make a submission to the Board of Taxation in relation its consultation paper on the implementation of the OECD anti-hybrid rules contained in its report on Action Item 2 – Neutralising the Effects of Hybrid Mismatch Arrangements ("the Report").

Background and context

Hybrid mismatch arrangements are defined in the Report as those arrangements that exploit the differences in tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. The focus of the Report is ostensibly on related party dealings and makes the observation that by neutralising the mismatch in tax outcomes, the rules will prevent these arrangements from being used as a tool for BEPS without adversely impacting cross-border trade and investment. The CTA is supportive of changes to Australian law which are directed at neutralising BEPS activity, however we firmly believe Australia should implement any changes in a measured way and as part of the wider tax reform agenda. We see this approach as critical in mitigating international perceptions that Australia is an increased sovereign risk.

We note the OECD state at page 11 of the Report that "these types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned". However we question if that assessment is reflective of the position in Australia, given the current robustness of Australia's rules. Australia currently has a comprehensive suite of tax integrity policies that to a large extent operate to negate potential international mismatches including:

- domestic debt/equity classification rules
- dividend imputation rules

Level 11, 455 Bourke St,
Melbourne Victoria 3000
Telephone: (03) 9600 4411
Facsimile: (03) 9600 4055
Email Address: admin@corptax.com.au

- thin capitalisation rules
- controlled foreign company rules
- transfer pricing rules
- withholding tax
- Division 768A which denies exemption for distributions on certain non-equity interests
- domestic hybrid entity rules; and
- overarching anti-avoidance rules in Part IVA (which include franking credit arrangements and the recently introduced multinational anti-avoidance rule).

The strength of these rules appears to be supported by figures released by the Parliamentary Budget Office, which estimated the cost of hybrid arrangements at $50 million per annum.[i] Current MYEFO estimates of corporate tax collections for 2015-2016 are $68 billion, so at one level the impact of such arrangements are small at 0.7% of total corporate revenue collections.[ii] In our view, any legislative response and the timing thereof should be commensurate with the risks to the revenue and the compliance costs involved in administrating any such measures.

The need for listed security carve outs

We strongly recommend that any anti-hybrid rules have specific carve outs for listed hybrid instruments. This is particularly relevant to Australian financial institutions that have on issue hybrids which are considered regulatory capital, but also other corporates raising funds in the global market. Such instruments are priced to reflect the relevant tax treatment in home and overseas jurisdictions. To deny a deduction to the corporation (or the secondary response of possibly denying a franking credit to investors if the counterparty jurisdiction has not implemented anti-hybrid rules) in Australia for such an instrument will increase the cost of capital which ultimately will be reflected in interest rates and/or will impact profitability, growth, innovation and jobs.

For example if a hybrid was issued out of Australia was considered non-share equity and frankable in Australia and deductible in New Zealand (NZ), and NZ has not introduced an anti-hybrid rule, Australia would presumably deny the franking credit under the secondary response to effectively subject the distribution to tax. As the returns on such hybrids are priced including any imputation credit, the pre-imputation coupon on the hybrid would need to be increased to keep third party investors whole, which is passed on to NZ as higher deductible payment. Although Australia may gain tax revenue on the increased unfranked coupon, NZ loses the corresponding tax as it allows a deduction for the higher interest rate, If NZ was to introduce an anti-hybrid rule and deny the deduction, and it raises the cost of capital in NZ. Australia is not impacted as it doesn’t need a secondary response.

Any anti-hybrid rule should be principle based

In our view, to strike the right balance between integrity of the tax system and the potential sovereign risks involved, the best approach would be to introduce a principles based anti-hybrid rule with a specific carve out for public issued securities. Such an approach has the advantage of dealing with iterations of hybrids that are not currently in the market.

We would also recommend that any principles based anti-hybrid rule be supplemented by appropriate guidance material from the ATO on how it proposes to administer its operation. This could possibly involve incorporating the examples contained in the Report. The guidance material should also include details of how the ATO proposes to provide compensating adjustments in circumstances where withholding taxes may have been paid on a tax deductible payment that is subsequently determined to be non-deductible under the approach proposed by the OECD.

We would also recommend that should any payment be treated as a non-deductible payment under any anti-hybrid rule that any referable hybrid debt instrument should be excluded from adjusted average debt calculation under existing thin capitalisation rules to ensure any debt deduction is not denied twice.

Australia should be measured in its approach

Although the idea suggested in the Report of primary and secondary responses to the implementation of anti- hybrid rules has some merit in dealing with transitional issues of staggered global implementation of the Report recommendations, it is our view that the introduction of any rules commence for arrangements entered into after 1 July 2017.[iii] This will provide a reasonable window for other OECD jurisdictions to have at least announced that they propose to implement the OECD recommendations and ensure the OECD primary response (ostensibly the denial of deductions in the payer jurisdiction) operates rather than secondary responses.

Relying on secondary responses in the Australian context (ostensibly being the inclusion of income that is not assessed) can be problematic as the inclusion of that income in Australia would result in that income being effectively Australian tax paid and could be passed on essentially tax free (or without withholding tax) to shareholders and thus does not deal with the very problem the anti-hybrid rules are meant to address. Although this could be theoretically resolved by having any tax paid in such cases as not generating a franking credit this could amount to double tax as the exempt dividend received from any such hybrid would not generate franked profits in any event. We note the Report at page 29 states that the anti-hybrid rules are only intended to operate where the payment gives rise to a mismatch in tax outcomes and is not intended to give rise to economic double taxation.

Should you have any questions in relation to the above, please contact me on (03) 9600 4411.

Regards

Paul Suppree
Assistant Director

[i] See http://billshorten.com.au/big-multinationals-to-pay-fair-share-under-labor

[ii] The UK has also estimated the revenue impact of mismatch arrangements and do not appear significant. See: https://www.gov.uk/government/publications/corporation-tax-anti-hybrid-rules/corporation-tax-anti-hybrid-rules

[iii] As a second best transitional rule, any anti-hybrid rule could apply to arrangements entered into before 1 July 2017 but allow an optional four year transitional period similar to that used when the debt-equity rules were introduced.