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The Board of Taxation
C/- The Treasury
Langton Crescent
Canberra ACT 2600
Attention: Karen Payne
Email: hybrids@taxboard.gov.au

15 January 2016

EY response: Implementation of the OECD Anti-Hybrid Rules

Dear Ms. Payne

We attach our submission to selected questions posed in The Board of Taxation consultation paper issued on 20 November 2015 on neutralising hybrid mismatch arrangements (anti-hybrid rules), pursuant to the recommendations of the G20 and OECD under Action Item 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan. We appreciate the opportunity to comment on the proposals.

The submission recognises that Australia will implement in whole or in part the recommendations contained in the OECD 2015 Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements*.

We highlight that the OECD recommendations are highly complex and framed on the basis that they represent a common direction or practice, and are not mandatory minimum standards for adoption by countries without change (as are some other recommendations). Countries are permitted to tailor their policy responses to their own domestic and economic requirements.

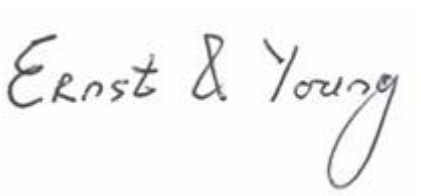
Our key proposition for the Board of Taxation is that in recommending any changes for Australia, there should be sufficient time provided to enable Australian companies and affected parties to assess the impact of the Australia specific rules and, where appropriate, restructure hybrid financing arrangements into non-hybrid arrangements. We accordingly encourage the Government to provide draft legislation well in advance of its effective date to enable taxpayers to properly consider the effect of the legislation and, where appropriate, to have sufficient time to restructure. It is imperative that any legislation would not be effective until a date some months after it is passed by Parliament.

We further recommend that Australia should not be an early adopter of the recommendations, as “front running” would be adverse to Australia’s competitiveness in attracting capital and investment. We note that the European tax laws are under development. Whilst it is acknowledged that alignment with all members of the OECD and the G20 member countries is not possible, the implementation of the recommendations ahead of other leading jurisdictions, sources of direct foreign investment and key trading parties could negatively impact Australia as an investment location and also prejudice Australian multinational businesses.

Our detailed answers to selected questions in the consultation paper are set out in the Appendix.

Please do not hesitate to contact either Brendan Dardis on (03) 9288 8080 or Tony Stolarek on (03) 8650 7654 should you wish to discuss any of these matters.

Yours sincerely,



Attachment

Appendix

The Board of Taxation – Implementation of the OECD Anti-Hybrid Rules - Consultation paper

Responses to selected questions

Q4. How should the anti-hybrid rules interact operationally with other parts of the Australian tax law?

(a) Should the anti-hybrid rules apply in priority to all other parts of the Australian tax law by virtue of an ordering rule? If so, should there be any exceptions?

The rules should apply in priority to all other parts of the Australian income tax law.

(b) Are there likely to be any interactions which give rise to unintended or inappropriate outcomes?

Thin capitalisation

- We highlight the need for appropriate interaction with Australia's thin capitalisation laws.
- Unless a specific amendment was developed, an inappropriate thin capitalisation outcome may arise where a debt deduction is denied under the anti-hybrid provisions but the debt remains included in "Adjusted Average Debt" for Division 820 purposes. For example, an Australian taxpayer may have a structure such as the Australia-US general partnership structure which gives rise to a DD outcome. Under OECD recommendation 6, Australia (the parent jurisdiction) should deny the deduction. Commercial constraints may practically prevent the group from refinancing the external debt into non-hybrid financing.

  For Australian thin capitalisation purposes, "*Adjusted Average Debt*" in section 820-85(3) (for Outward investing entities (non ADI)) comprises in Step 1 of the Method Statement the *"…average value, for that year (the relevant year), of all the *debt capital of the entity that gives rise to *debt deductions of the entity for that or any other income year*".
- A "*debt deduction*" is defined in section 820-40 and includes interest and amounts in the nature of interest. Under the current law, the interest amount retains its characterisation as a "debt deduction" if the borrower can, apart from Division 820, deduct the interest from its assessable income for that year (per paragraph 820-40(1)(b)). That means that the relevant hybrid financing would adversely affect the position of the entity for thin capitalisation in addition to any denial of interest pursuant to any laws dealing with hybrid financial arrangements. The same outcome would arise, for example, where hybrid financing is provided by way of a hybrid financial instrument by a foreign parent to an Australian subsidiary resulting in a D/NI outcome which is denied under recommendation 1.

  It is inappropriate for an amount of debt on which no deduction is potentially available in the income year by virtue of the application of the anti-hybrid rules to still be included as adjusted average debt by virtue of it having given rise to debt deductions in the current or prior years. It is recommended that Division 820 be amended to address this inappropriate consequence.

Application of Australian anti-avoidance provisions to restructuring arising as a result of the anti-hybrid rules

- There should be a specific provision within either Part IVA or the anti-hybrid provision that provides that any restructure undertaken in consequence of the anti-hybrid rules should not attract the application of Part IVA. Absent such a provision, for example, a restructure of hybrid debt by an Australian taxpayer to vanilla debt which has the effect of retaining the Australian debt deduction may constitute a "tax benefit" and the tax outcomes might be denied under Part IVA.

(c) Should the anti-hybrid rules be incorporated as amendments to specific areas of the existing tax law (such as, for example, the debt/equity rules) or sit as a separate, overarching code?

It is recommended that the core amendments should be incorporated as a separate Division within the Income Tax Assessment Act 1997.

Q6. What is an appropriate commencement date for the anti-hybrid rules? For example, 1 July 2017 or later?

There are a number of factors that should be taken into account in determining the commencement date for the anti-hybrid rules. It is accepted that Australia will undertake some policy response to the recommendations of the October 2015 OECD Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements.*

Accordingly, as outlined below, we recommend that the commencement date should at a minimum be at least 6 months from the time that detailed legislation is passed by Parliament.

a) There should however be sufficient time provided to enable Australian companies to assess the impact of the specifically proposed rules and, where appropriate, restructure hybrid financing arrangements into non-hybrid arrangements.

b) The detailed assessment of the impact of the rules can only be done once final legislation has been passed by the Parliament and has received Royal Assent, which is a later date than when the draft legislation is provided by the Government. This is required to enable taxpayers to accurately assess the impact of the legislative changes and to appropriately consider actions required. Given that the Board of Taxation is only to report by the end of March 2016 and for the government to consider the report and determine its actions, it is considered that a start date of 1 July 2016 would be highly inappropriate.

c) We highlight it is critical to avoid situations such as the numerous income tax amendment measures announced by the former governments in the 2007-2013 period which were not supported by draft legislation and have not yet become law (some of which have been announced as having retrospective effect). Unlegislated announcements, particularly those which impact third party transactions, create significant uncertainty which affects Australian businesses. One problematical issue, for example, relates to the status of tax consolidation amendments proposed in the 2013 Budget by a former government with immediate effect (based on a Board of Taxation report, but despite the recommendation of the Board of Taxation that any changes should take effect only after Royal Assent). These contentious amendments are still under policy development, have still not been legislated and are theoretically applicable up to three years ago.

   Tax law amendment by announcement without supporting legislation is inappropriate due to its uncertainty. A further key principle is the need for appropriate lead times, even more so in an area of complexity which relates to financial transactions which might involve third parties directly or indirectly, such as the anti-hybrid area.

d) The timing of actions being taken by Australia's major trading partners should also be taken into account in determining an appropriate start date. The only country that has publicly announced its intention for complete implementation of the anti-hybrid rules is the UK with a commencement date of 1 January 2017.

The UK government has announced that it will implement Action 2 amendments with effect from 1 January 2017 and has released detailed draft legislation on 9 December 2015 which provides UK taxpayers with over 12 months to assess the impact and implement restructures if appropriate.

The draft UK law comprises 47 pages of amendments which reflects the complexity of the measures and reinforces the need for sufficient time to be provided for taxpayers to assess the impact and it is expected that this should similarly be the position adopted in Australia. A fair and competitive Australian response should require no less.

Leading the BEPS hybrid discussions, Germany had drafted an anti-hybrid rule in October 2014 (justifying the proposal with the draft BEPS report on hybrids as of September 2014) but that was not introduced into Parliament and was postponed until after the final OECD reports in October 2015. According to statements of government officials, a working group of German federal and state level representatives established in early 2015 is coordinating the German implementation of the anti-hybrid rules. A draft bill is expected to be published in the second quarter of 2016 and we assume that it will consider the measures of the so called European Union (EU) anti-Base Erosion and Profit Shifting Directive which is expected to be presented in early 2016 as well. The Economic and Financial Affairs Council of the European Union has indicated that further work needs to be done on the EU Directive and we expect that the implementation of the anti-hybrid rules into domestic tax law of other EU member states depends on the final measurements released by the EU. Thus we expect that EU policy development is unlikely to conclude soon.

Given these ongoing developments we would recommend that Australian detailed policy development should target harmonising the adoption of the recommendations with these key jurisdictions.

e) The implementation of the anti-hybrid rules may be expected to increase the cost of capital for investment into Australia for foreign investors that may otherwise avail themselves of hybrid financing and similarly increase the cost of capital for Australian multinationals that may currently avail themselves of hybrid financing. Ideally, the Australian commencement date should not precede that of Australia's major investor and investee locations and trading partners so as not to negatively impact Australia's competitiveness. It is however recognised that total harmonisation in this regard is not possible.

f) We accordingly recommend a commencement date which is both later than 1 January 2017 and which is at least 6 months subsequent to the Parliament's adoption of detailed legislation and a stated commencement date.

The Discussion Paper referenced as an example a potential 1 July 2017 start date. Subject to the comments above, we submit that that would be the earliest possible commencement date.

Q21. ***Should Australia adopt the special rule in recommendation 5 to amend the CFC rules, limit the tax transparency for non-resident investors and require information reporting for intermediaries? If changes to the Australian CFC rules are adopted, do you foresee any particular compliance challenges?***

Where the anti-hybrid rules are introduced in a manner that has application in priority to other parts of Australian tax law, it is considered that the Recommendation 5 package of specific recommendations for the tax treatment of payments to reverse hybrids is not necessary. The application of the anti-hybrid rules and existing CFC provisions and section 23AH should appropriately deal with D/NI outcomes without the additional complexity of recommendation 5 specific recommendations.

Q35. Whether hybrid arrangements that form part of a financial institution's regulatory capital should be carved out of Australia's anti-hybrid rules? Could (and should) any carve out be limited to regulatory capital issued to third parties?
Q36. Are there any other regulatory capital concerns that require special rules?

We support an exclusion for the application of the anti-hybrid rules for hybrid arrangements that form part of a financial institution's regulatory capital (in line with the position adopted by the United Kingdom).

Q37. With the exception of those suggested in the Action 2 Report, whether there are any other types of entities that should be excluded from the operation of the anti-hybrid rules?
Q38. Whether there are particular types of transactions that should be excluded from the operation of the anti-hybrid rules?

We support maintaining tax neutrality of certain financial entities, such as securitisation vehicles and investment companies/trusts in accordance with the exceptions contained in paragraph 102 of the 2015 Final Report.

We note also that financing techniques such as mandatory redeemable preference shares might be used in infrastructure projects. Therefore, the policy implementation and transitional mechanisms should have regard to consultations with that sector.

Q39: The Board invites comments from stakeholders on whether a principles based drafting approach, or a black letter approach should be adopted in drafting the anti-hybrid rules.

A principles based drafting in line with the stated policy objectives is recommended.