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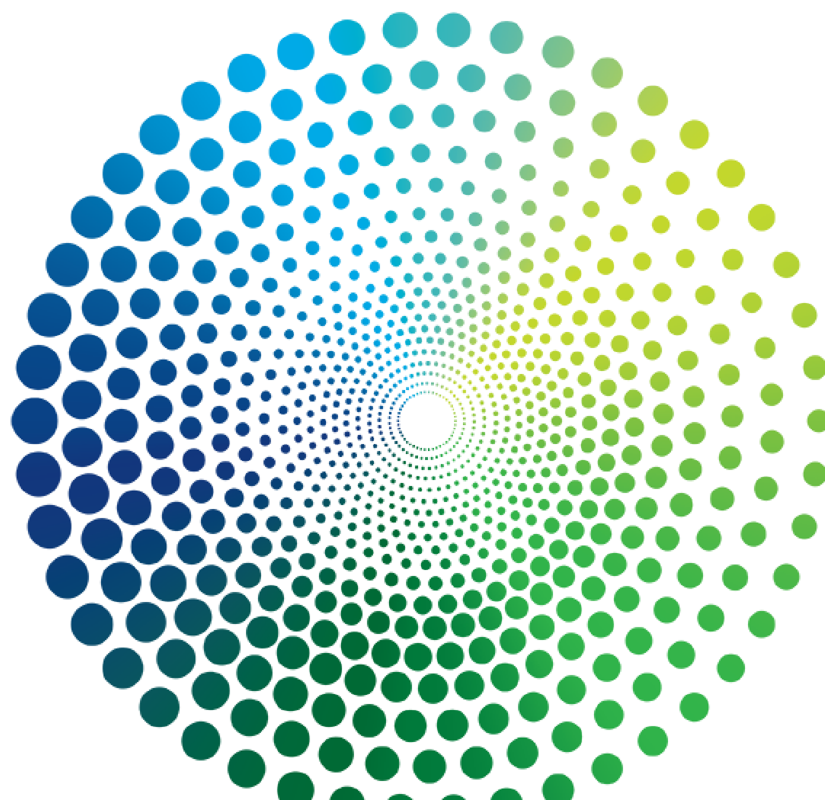

Tax Insights

Imported hybrid mismatches – Final ATO guidance released

Snapshot

On 16 December 2021 the ATO released its final compliance guideline and risk assessment framework in relation to the imported hybrid mismatch rule. This finalises the draft released earlier this year and comes as many taxpayers are ending their second income year in which the far reaching and highly complex imported mismatch rule applies to cross-border arrangements.

Since their introduction in 2018, the hybrid mismatch rules (and in particular the imported hybrid mismatch rules) have presented Australian taxpayers with the new and significant challenge to understand not only the Australian tax implications of their cross-border arrangements but also the foreign tax implications. For years commencing on or after **1 January 2020** this has become even more complex, with the onset of the **imported mismatch rule** for non-structured

arrangements, requiring Australian taxpayers to understand if their deductible payments fund a hybrid mismatch anywhere else in their global group[1].

The draft PCG released in May 2021 set a high bar for compliance, with the Commissioner indicating that taxpayers **should not claim a deduction for related party cross-border expenditure unless they are able to obtain sufficient information to support a conclusion that the imported mismatch rules do not apply**. This position remains in the final PCG[2]. The key changes in the final PCG since the draft release in May 2021 are:

- A combination of the 'top-down' and 'bottom-up' approach may satisfy the ATO's recommended approach. Stringent adherence to the steps of either the 'top-down' or 'bottom-up' is not required as long as the outcome of the enquiries provides sufficient evidence to form a conclusion.
- The familiar traffic light risk assessment framework has been revised so that the Amber zone is now 'high risk' and the Red zones are 'very high risk'. In this regard the PCG refers to the use of formal powers for information gathering and continuous presence in the Red zone as resulting in compliance review as a matter of priority. Taxpayers who do not complete reasonable enquiries or undertake a review of their imported mismatch risk will automatically be considered to fall within the very high risk Red Zone 2.
- For the period of 18 months from the finalisation of the PCG a reduction in shortfall penalties and interest will be considered if taxpayers make a voluntary disclosure in relation to all income years in which an imported mismatch arrangement is in place.
- The lower risk zones have been modified so that groups that are able to verify that at least 90% of their total payments do not give rise to a hybrid mismatch (or have been neutralised) will now be considered low-moderate risk and groups with less than A$250m turnover in Australia (based on the economic group, not the taxpayer group) will qualify as moderate risk if they can demonstrate compliance with a global policy to manage hybrid mismatch risks that is consistent with the OECD BEPS Action 2 Report.

Unfortunately, the PCG does not provide taxpayers with any further guidance on how to determine whether another country has 'corresponding' foreign hybrid mismatch rules or rules that have 'substantially the same effect', although this is a consideration in the ATO recommended approaches. It is understood that this guidance is still under development by the ATO.

The PCG confirms that a self-assessment of the risk zone may be required in the Reportable Tax Position schedule. It is also understood that the ATO proposes to amend Section G of the International Dealings Schedule in 2022 to require more detailed disclosures relating to offshore hybrid mismatches, meaning that Australian taxpayers of multinational groups will have a significant burden to consider these rules carefully in order to meet their compliance obligations.

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[1] The imported hybrid mismatch rule applies to importing payments made under structured arrangements that are covered by table item 1 of subsection 832–615(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) for income years that commenced on or after 1 January 2019. For importing payments made directly or indirectly to an offshore deducting entity that are covered by table items 2 or 3 of subsection 832–615(2), the imported hybrid mismatch rule applies for income years that commenced on or after 1 January 2020.

[2] Paragraph 24 of the PCG

Key takeaways

- Cross-border payments which are otherwise deductible in Australia and which are made to, broadly, a member of an accounting consolidated group or an entity with 50% or more common ownership (referred to in this publication as **related party payments**) must be examined from the perspective of the imported mismatch rule and supporting information obtained prior to the lodgement of the relevant tax return. An Australian tax deduction should not be claimed unless the taxpayer has sufficient evidence to support a conclusion that the imported mismatch rule does **not** apply.
- The ATO takes the view that for a **structured arrangement**, the taxpayer has all relevant information necessary, or will be able to obtain that relevant information from the other parties to that structured arrangement.
- The PCG is principally concerned with the taxpayer's obligations to take **reasonable care** in connection in ascertaining relevant facts so as to apply the law to a **non-structured arrangement**.
- For **non-structured arrangements**, reasonable care to comply with the rule will be considered to have been taken if:
  - A taxpayer follows the ATO's "recommended approach" of either:
    - Following a '**top-down**' review approach that starts with identification of offshore hybrid mismatches and filters that information down to deductible related party payments made by the Australian taxpayers;
    - Following a '**bottom-up**' tracing approach that repeats until all relevant related party payments have been verified; or
    - A combination of the top-down and bottom-up approaches; and
  - It is not the case that:
    - There is information known, or that should have been known, by the taxpayer or their agent, and the failure to consider that information leads to a tax shortfall; or
    - A member of the group has deliberately withheld information; or
    - A member of the group has deliberately provided false or misleading information.
- Taxpayers and their agents will generally not be able to demonstrate reasonable care if a related party deduction is claimed and 'they have not made enquiries or have not received adequate and complete responses from responsible qualified individuals', and it is subsequently found that the imported mismatch rule applied. Given the self-assessment nature of the hybrid rules, this places the compliance burden squarely on the taxpayer.
- The focus on reasonable care is in the context of Division 284 of the *Taxation Administration Act 1953*[3]. Amongst other penalties, Division 284 includes penalties for failure to take reasonable care to comply with a taxation law.
- When the hybrid measures were introduced, it was noted that "It is likely that, where possible, many taxpayers will restructure out of hybrid arrangements that would otherwise be subject to the OECD hybrid mismatch rules (including arrangements subject to the integrity rule) and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules"[4]. The ATO notes in the PCG that "Taxpayers, and their Division 832 control groups, may

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[3] Administrative penalties for statements, unarguable positions and schemes.

[4] Paragraph 1.20, Explanatory Memorandum, Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018.

look to mitigate the cost of compliance by endeavouring to eliminate hybrid mismatch arrangements, including offshore hybrid arrangements, to which Division 832 could apply"[5].

- Where offshore hybrid arrangements remain in place, the PCG states the ATO view that "For a taxpayer to be satisfied that they are entitled to deductions for cross-border payments that they make to members of its Division 832 control group, the taxpayer must determine whether any of their cross-border payments result in an offshore hybrid mismatch being directly or indirectly imported into Australia … A taxpayer should **not** claim a deduction for a payment unless they are able to **obtain sufficient information** to support a conclusion that the deduction in respect of the payment is **not** disallowed under Subdivision 832–H.

  Where the taxpayer later obtains further information that confirms entitlement to a deduction for that payment, they can lodge an amendment request to claim the deduction"[6].

Recap: what is the imported mismatch rule?

The hybrid mismatch rules are the implementation of the OECD BEPS Action 2 Report and are essentially provisions that deny deductions or include an item in assessable income to 'neutralise' the effect of a one-sided tax deduction or a double deduction, commonly referred to as 'double dips' and technically called 'deduction / non-inclusion' mismatches (**DNI**) or 'deduction / deduction' mismatches (**DD**). The hybrid rules and the imported mismatch rule do not contain a purpose element, and hence are much broader than the general anti-avoidance laws. There is also no scope limitation or de minimis rule and the types of deductible payments which can be impacted include a broad range of deductible expenses such as interest, royalties, leases, management fees and purchase of goods or services.

The imported mismatch rule is an integrity measure contained in the hybrid mismatch rules. It applies where an Australian taxpayer makes an otherwise deductible payment to another entity which directly or indirectly funds an offshore DNI or DD mismatch.

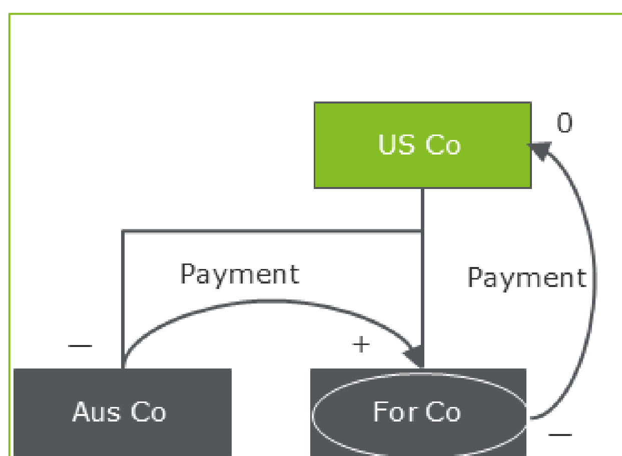
For there to be a denial of a deduction to an Australian taxpayer for a **non-structured arrangement,** broadly the following two components needs to exist in an income year:

1. There is an **offshore hybrid mismatch** involving two foreign related parties, such as a hybrid financial instrument or a hybrid entity structure that gives rise to a DNI or DD mismatch; and
2. The Australian taxpayer must have made an **importing payment** that directly funds the offshore deducting entity, or indirectly funds the offshore deducting entity via a series of payments through interposed entities that are assessable/ deductible through the chain of entities.

[5] Paragraph 10 of the PCG.

[6] Paragraphs 21 and 24 of the PCG.

Simple example



- Aus Co makes an otherwise deductible payment to For Co
- For Co is subject to income tax in its local jurisdiction on the payment from Aus Co
- For Co makes a payment to US Co, which is deductible to For Co in its local jurisdiction
- US Co is not subject to income tax in the US on the payment from For Co, on the basis that For Co has effectively been treated as a branch of US Co under the US 'check the box' rules, such that the transaction between US Co and For Co is disregarded for US tax purposes.

The imported mismatch rule also applies to both 'structured arrangements' and non-structured arrangements, with the latter applying (broadly) to transactions within a 'controlled group'. The application of the rules only began for **non-structured arrangements** from income years beginning on or after 1 January 2020. This aligns with the inception date of the application of hybrid mismatch rules in the European Union under Anti-Tax Avoidance Directive II. This is relevant because payments made to entities that are taxable in a country that has implemented their own 'foreign hybrid mismatch rules' should not give rise to an imported mismatch. Whilst there is little guidance on when foreign laws will qualify as 'foreign hybrid mismatch rules', EU countries, the UK and New Zealand are expected to comply. Despite this issue being raised in ATO consultations this issue remains on the ATO's pending advice under development list.

For income years beginning between 1 January 2019 and 31 December 2019, multinational enterprises should focus on any payments that are made under a scheme where a DNI or DD mismatch was a 'design feature' of the scheme[7]. The concept is extremely broad and remains important post 1 January 2020 as such arrangements are denied in priority to non-structured arrangements.

[7] The Commissioner's view of this is contained in PCG 2019/6.

ATO's recommended approach

The ATO's recommended approach for **non-structured arrangements** is set out in paragraphs 30 to 50 of the PCG.

Top-down approach

1. Obtain the core information from the Global Head of Tax
2. Filter information by Australian tax manager
3. Quantify the offshore hybrid mismatch
4. Identify any interposing payments and quantify the imported mismatch.

Bottom-up approach

1. Identify all potential importing payments
2. Identify mismatch outcomes for the direct tested entities
3. Identify potential interposed payments made by direct tested entities
4. Identify and follow payments.

Further detailed steps are set out in the Appendix to the PCG describing the expected information gathering that will be undertaken to meet the above. For example, the Appendix includes the identification of all in-scope offshore payments, and then for each such payment requires a description of:

- 11 characteristics of the payment associated with a DNI transaction; or
- 7 characteristics of the payment associated with a DD transaction.

The ATO expects that enquiries will be made of "suitably qualified or responsible individuals": this will include "the person primarily responsible for the Group's tax obligations, such as the Head of Tax for the Group, and may also include other appropriate qualified responsible individuals or suitably qualified representatives".

The PCG also provides some basic examples of common fact patterns that may apply:

Example	Summary of ATO position
1. Payments made indirectly via an interposed entity In this example Aus Co, B Co and C Co are members of the same Division 832 control group and make a number of commercially and temporally unrelated payments for interest and royalties. Aus Co makes a deductible payment of interest to B Co of $200; B Co makes a deductible payment of interest to a third party of $200 and a deductible royalty payment to C Co of $50	Because payments exist between the entities, Aus Co has an identified indirect payment to C Co for the purposes of the imported mismatch rule.

2. Followed the ATO recommended approach In this example Aus Co is a subsidiary of a US multinational and the Aus Co tax manager has made enquiries to determine that a disregarded foreign entity exists in the group and has given rise to a DD mismatch, but that the disregarded entities' income under US tax law exceeds its deductions.	The Aus Co tax manager has followed the ATO recommended approach because the enquiries have determined that the potential offshore mismatch amount is nil. This example indicates that the ATO will accept that there is a nil offshore mismatch where a US disregarded entity is a taxable profit scenario for *US tax purposes*, i.e., regardless of whether there is a foreign country loss.
3. Analysis of corresponding foreign hybrid mismatch rules Aus Co is a subsidiary of Head Co and both entities make a deductible payment to B Co, another subsidiary of Head Co. Head Co has assessed that its payment to B Co does not give rise to an imported mismatch risk under the tax laws of its jurisdiction.	The assessment by Head Co of its imported mismatch rule risk in relation to its payments to B Co cannot be relied upon by Aus Co. This will be instructive to European headquartered groups where hybrid mismatch rules have or are being been assessed globally. The ATO expectation is clearly that taxpayers undertake a substantive review of the rules through an Australian lens.

ATO's risk assessment framework

A risk assessment framework sets out the Commissioner's view on the level of compliance risk, which will be disclosable in the Reportable Tax Positions Schedule.

Risk Zone	Risk Level	ATO treatment	Example
White	Self-assessment of risk rating not necessary	No review other than to confirm ongoing consistency with the agreed/determined approach.	• Engaged with the ATO and demonstrated not within scope of the imported mismatch rules; or • Imported hybrid risk already dealt with in a pre-lodgement compliance review and assessed as "low risk" or "high assurance"; • In the white zone per the above in any of the last two income years, and confirmation that the circumstances have not materially changed.
Green	Low risk	No review other than to confirm you have satisfied the necessary criteria to fall within the low risk zone.	• You have followed the ATO recommended approach and have sufficient evidence to conclude there are no imported mismatch risks; • You were in the green zone for two preceding income years and circumstances have not materially changed; • You have not obtained sufficient information and have not claimed a deduction as a result; or • Otherwise deductible payments are less than A$2m

Risk Zone	Risk Level	ATO treatment	• Example
Blue	Low-moderate risk	Limited review to confirm that your arrangements are low to moderate risk.	• You have made reasonable enquiries and verified at least 90% of total payments; or • You were in the blue zone for two preceding income years and circumstances have not materially changed
Yellow	Moderate risk	We may apply compliance resources to review your compliance methodologies and outcomes.	• Your global group has a global policy for managing imported hybrid mismatch risk in accordance with OECD BEPS Action 2 Report and you have applied this policy; and • Turnover of the Australian economic group is less than $250m
Amber	High risk	We are likely to apply compliance resources to review your compliance methodologies and outcomes and resolve any areas of difference.	• Evidence obtained using the ATO recommended approach that is sufficient to demonstrate compliance; and • You have adopted a position contrary to ATO advice.
Red 1	Very high risk	Reviews of your compliance methodologies and outcomes will be commenced as a matter of priority. Cases might proceed directly to audit. We are likely to use formal powers for information gathering.	• You have made a payment under a **structured arrangement** and you do not have evidence to demonstrate that the mismatch has been correctly neutralised ; or • You have not treated a payment as an importing payment under a structured arrangement only because a position has been taken that the payment was not made directly or indirectly through interposed entities.
Red 2		A continuous presence in this zone (that is, two or more years), is likely to result in the commencement of reviews of your compliance methodologies and outcomes as a matter of priority.	• You have made a deductible payment to a member of the Division 832 control group and claimed a deduction but do not fit in any other risk zone, including where insufficient information has been obtained

The ATO states that "if you are outside the low risk zone, we do not presume that your related-party arrangements fail to comply with the Australian tax law. However, where a taxpayer is outside a low risk zone, we consider that there is a greater risk that your related-party arrangements will give rise to inappropriate tax outcomes. In these cases, we are more likely to conduct some form of engagement and assurance activity to further test the taxation outcomes of your arrangements".

The PCG applies before and after the date of issue.

What should you do?

The imported mismatch rule and the PCG applies to Australian multinational groups as well as Australian subsidiaries of foreign multinationals, but the latter group have a far greater challenge, given the information that they will need to analyse the imported mismatch rule risk, will reside outside of Australia.

The Commissioner's warning that formal information gathering powers and immediate audit proceedings may be initiated for the very high risk zones is indicative of the ATO's approach to demand a very high standard for global reviews. Australian taxpayers and public officers together with their tax agents should therefore be carefully considering their tax compliance obligations.

Deloitte's approach to assess the application of the imported mismatch rules is to:

- Consider the PCG in the context of your tax governance framework.
- Review your global group structure and related party dealings profile to assess whether the top down, bottom up or a combination of approaches is best suited
- Identify the responsible representatives within the global group that will qualify for the ATO's recommended approach. The PCG indicates that this must include the person primarily responsible for the Group's tax obligations from a global perspective, such as a Head of Tax, and may also include other treasury and finance representatives and regional tax managers.
- Consider your systems' capability to apply one of the recommended approaches and prepare relevant information request lists. The Appendix to the PCG contains a 'general guide' which is a non-exhaustive list of information that the ATO expects would be obtained in order to demonstrate compliance, which is very detailed.
- Perform a risk assessment and obtain relevant supporting information prior to lodging your return, noting that if no information or insufficient information is obtained and you have related party payments in excess of $2 million, the very high risk zone will automatically apply.

As we reach the end of the calendar 2021 year and many taxpayers now have two years of imported mismatch rule application to self-assess, considerations from an accounting and tax provision perspective are also becoming evident.

These rules and this PCG should be considered as a matter of priority for multinational groups, particularly as the ATO guidance is that "a taxpayer should not claim a deduction for a payment unless they are able to obtain sufficient information to support a conclusion that the deduction in respect of the payment is not disallowed".

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