30 June 2022
Australia 2022/8

Tax Insights

Hybrid Mismatch Rules – US GILTI rules do not correspond to Australia's CFC rules

Snapshot

On 29 June 2022 the Australian Taxation Office (**ATO**) released its final determination (TD 2022/9, the **Determination**) in relation to whether section 951A of the US Internal Revenue Code (the **US GILTI rules**) correspond to section 456 or 457 of the *Income Tax Assessment Act 1936* (**Australia's CFC rules**) for the purpose of subsection 832-30(5) of the *Income Tax Assessment Act 1997* (**Australia's hybrid mismatch rules**).

In concluding that the US GILTI rules **do not correspond** to Australia's CFC rules, the ATO further concludes that an amount that is subject to tax for the purpose of the US GILTI rules will **not** be considered as "subject to foreign income tax" for the purpose of Australia's hybrid mismatch rules.

An important consequence of the view expressed in the Determination, therefore, is that taxpayers **cannot** rely on amounts being subject to the US GILTI rules to support that those amounts have been included in the calculation of a foreign tax base to mitigate or eliminate the application of the Australian hybrid mismatch rules.

The conclusion is consistent with that expressed by the ATO draft Taxation Determination TD 2019/D12 (the **Draft Determination**) and, for that reason, is not unexpected.

Unlike the Draft Determination, the Determination does not rely on the contrast between the calculation mechanics of the GILTI rule versus the Australian CFC rules (i.e., worldwide aggregation vs entity by

entity calculations) as a characteristic to support non-correspondence. Instead, the Determination leans on concluding that the 'gist' of the GILTI rule and sections 456 and 457 have **substantive differences** and they are not 'designed to produce the same result'. Furthermore, the Commissioner views that subsection 832-130(5) both clarifies, and acts independently of, subsection 832-130(1), which provides the primary definition of 'subject to foreign income tax'.

A smaller but favourable outcome for taxpayers can be found in the compendium to the Determination (the **Compendium**), whilst only providing non-binding commentary, indicates that the purpose of section 951(a) of the US Internal Revenue Code (commonly referred to as the US 'SubPart F' rules) is "likely" to correspond to sections 456 or 457 and therefore considered a relevant inclusion in the context of Australia's hybrid mismatch rules. It is expected that many taxpayers would have taken this view, but the explicit commentary should provide some comfort on taking this position.

Context of the guidance

The Determination addresses a topic which has been listed under the ATO's advice under development program and should provide clarity on this specific area of uncertainty for many taxpayers coming to grips with how the hybrid mismatch rules impact their Australian businesses as part of a global group structure.

Unfortunately for taxpayers, the Determination explicitly states that it does not address what 'corresponds to' means in other contexts, such as when employed in the definition of 'foreign hybrid mismatch', which is an important definition which many taxpayers are grappling with in order to appropriately assess the application of the imported hybrid mismatch rule, which itself was the subject of a recent Practical Compliance Guideline, PCG 2021/5 (see Tax Insights dated 16 December 2021).

Australia's hybrid mismatch rules implement Australia's adoption of the OECD Action 2 recommendations to eliminate the effect of mismatches in the tax treatment of instruments and entities. The rules are complex but broadly apply where a payment is made under a hybrid arrangement and gives rise to a 'deduction/non-inclusion' outcome or a 'deduction/deduction' outcome.

For **payments made by Australian businesses**, the key concept used to determine whether there is a 'deduction/non-inclusion' is whether the amount is 'subject to foreign income tax', which primarily tests whether the amount is included in the tax base of a foreign country of the recipient. The definition also contains a specific extension, however, where the amount is included in working out the tax base of another entity under a provision of a law of a foreign country that corresponds to Australia's CFC rules. In other words, the inclusion of the amount via an equivalent CFC regime should be sufficient for the amount to be considered as subject to foreign income tax for the purpose of Australia's hybrid mismatch rules. This extension effectively represents the optional OECD Action 2 recommendation that countries take account of a CFC inclusion. The subject to foreign income tax definition is also relevant to determining amounts of 'dual inclusion income' which can shelter certain hybrid mismatch payments.

Australia's hybrid mismatch rules therefore require that Australian businesses understand how cross border payments are treated in the hands of foreign counterparties to their arrangements. The ATO has recognised the difficulty in determining this by listing foreign law interactions under its advice under development program since the introduction of the hybrid mismatch rules. In this context, the US GILTI rules are a foreign law that businesses and commentators queried almost from the time of their implementation given it occurred around the time many countries were seeking to introduce hybrid mismatch rules and, indeed, that the US GILTI rules were situated within the US SubPart F rules (the relevance of which has been dismissed by the ATO in the Compendium commentary).

Interpretational guidance

Central to the Determination is that it expresses an interpretation of the meaning of 'corresponds to' as requiring something to be similar, analogous or equivalent in function. It takes guidance from the Explanatory Memorandum (EM) to the hybrid mismatch rules and obiter in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092* and *Winter v Ministry of Transport* [1972]

NZLR 539 to form the view that rules must be consistent on an overall level and that similarities should be recognisable in their 'effect' or 'gist'.

It contains a brief outline of the Commissioner's understanding of the US GILTI rules and identifies the following key aspects:

- CFC-level items that that are taken into account by the GILTI rule include tested income, tested loss and qualifying business asset investment (**QBAI**);
- Net CFC tested income, determined on an aggregate basis;
- Net deemed intangible income return; and
- The legislative history and broader GILTI regime, including sections 250 and 960(d) of the US Internal Revenue Code which enable US shareholders to offset foreign tax credits and a specific deduction for amounts included under the GILTI rule.

The US GILTI rules are described as a global minimum tax regime for which there is **no equivalent** in Australia. This description is anchored in the US legislative history as understood by the Commissioner that the GILTI rule was introduced to protect the US tax base against erosion through the concentration of a multinational businesses high value functions, assets and risks in low taxed jurisdictions. The QBAI reduction to the amount included under the GILTI rule is determined to be a key feature of the rule which signifies that it is a global minimum tax rule.

In contrast, Australia's CFC rules are described as the operative provisions of a general CFC anti-deferral regime, the policy intent of which is to assess Australian attributable taxpayers on an accruals basis in relation to particular passive and tainted income.

Accordingly, the Determination concludes that the 'effect' or 'gist' of the US GILTI rules is one of a global minimum tax, which is **sufficiently dissimilar** to an anti-deferral regime that operates in relation to the derivation of items of tainted income under Australia's CFC rules.

Practical impact

As noted, an important consequence of the view expressed in the Determination is that taxpayers **cannot** rely on payments being subject to the US GILTI rules to support that those amounts have been included in the calculation of a foreign tax base to mitigate or eliminate the application of the Australian hybrid mismatch rules.

The Determination also ultimately increases the risk of **economic double taxation** arising where a payment, that has been included in the calculation of the tax base for US income tax purposes via the US GILTI rules, is still treated as giving rise to a deduction/non-inclusion mismatch for the purpose of Australia's hybrid mismatch rules. This double taxation outcome could be argued as being contrary to the general intent of the OECD recommendations in the Action 2 Report (and the stated policy of Australia's hybrid mismatch rules) to neutralise the effect of hybrid mismatch arrangements. Commentary included in the Compendium appears intended to pre-empt this point, however, by stating that the OECD recommendation was "subject to limitations" and that consistent with this, not all inclusions under a CFC regime are recognised under Australia's hybrid mismatch rules.

Although not explicitly addressed in the Determination it may also be that the same conclusion would be reached by the ATO in applying the targeted integrity rule (**TIR**) - which can disallow deductions for interest and certain similar payments that are not included in the calculation of a tax base to which a tax rate of at least 10% is applied - given this rule also includes a similar extension for inclusions arising under a controlled foreign company regime.

Ultimately, this Determination highlights the importance of understanding foreign tax law interactions when applying Australia's hybrid mismatch rules. This is further emphasised by the release of PCG 2021/5 noted above which outlines the ATO's expectations of the extent of work required to evidence compliance with Australia's hybrid mismatch rules as well as the additional disclosures required in the

most recently released International Dealings Schedule that accompanies Australian company income tax returns.

Australian businesses should continue to review their global structures to assess the impact of the hybrid mismatch rules and have regard to the impacts of this Determination. The ATO view is clear that Australian businesses should carefully consider the application of Australia's hybrid mismatch rules to all their arrangements and not assume that potential mismatches will be remedied by foreign tax laws.

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