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Deloitte Tax Essentials:
Understanding the
Hybrid Mismatch Rules

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Snapshot

The Australian hybrid mismatch rules (**HMR**) were introduced in response to the OECD's recommendations on neutralising a mismatch in tax outcomes arising from countries' different tax treatment of arrangements involving particular types of instruments or entities.

The HMR are implemented by **Division 832** of the *Income Tax Assessment Act 1997* (**ITAA 1997**) and generally have effect for income years beginning on or after **1 January 2019**.

Broadly, the HMR eliminate double non-taxation outcomes that arise from a 'hybrid arrangement'. These arrangements typically arise where there is:

- A **financial arrangement:** for example, a hybrid financial arrangement that is treated as debt in one country, but as equity by another, or a financial arrangement that gives rise to a timing deferral; or
- A **hybrid entity:** for example, an entity that is treated as transparent in one country, but opaque in another, and it either makes deductible payments, or receives payments which were deductible to another entity.

The HMR neutralise the hybrid mismatch by either **denying a deduction**, or **including in assessable income**, certain payments or amounts.

In addition, the HMR include a targeted integrity rule (**TIR**) which applies to deny deductions for related party interest or derivative payments that are taxed at a rate of 10% or less.

Is there a 'hybrid mismatch' arrangement?

The core principle for determining that there is a hybrid mismatch is whether there is a:

- Deduction / non-inclusion (**D/NI**) outcome: broadly, where a payment is deductible in one country, but not considered taxable income in the country it is received; or
- Deduction / deduction (**D/D**) outcome: broadly, where a deduction is allowed in more than one country for the same payment.

If a payment gives rise to a D/NI or D/D outcome, the HMR may apply if the arrangement also satisfies the conditions specific to one of the following hybrid arrangements:

01. Hybrid financial instrument
02. Hybrid payer entity
03. Reverse hybrid entity
04. Branch hybrid entity
05. Deducting hybrid entity (double deduction)
06. Imported hybrid mismatch

These rules apply in consecutive priority order. For example, a hybrid payer arrangement does not also give rise to a reverse hybrid arrangement. This is important as it can impact the potential amount of any denied deductions.

If none of the hybrid arrangements above applies, the TIR may nevertheless apply if the payment is interest or a payment under a derivative financial arrangement. Amendments passed in respect of Division 832 in September 2020 amend the ordering rule such that the TIR may also apply notwithstanding that the double deductions rule has already applied to a payment (and may not have neutralised some or all of the deduction). This means that foreign controlled hybrid entities and Australian branches should always consider the TIR in relation to any related party interest or derivative payments.

Each hybrid rule has its own unique 'hybrid requirements' and 'scope requirements', but broadly the rules apply to payments between:

- Members within the same '**control group**', which are broadly entities that have common control interests of 50% or more (not associate inclusive) or are members of the same accounting consolidated group;
- Parties under a '**structured arrangement**', which is broadly a scheme under which the hybrid mismatch is priced into the terms, or it is reasonable to conclude is a design feature of the scheme; and
- In addition, for **HFIs only,** '**related persons**', which are broadly entities that have a minimum 25% associate-inclusive control relationship.

Key takeaways

- The rules apply to a broad range of payments including financing, royalties, COGs, service fees and depreciation expense.
- The rules apply to a vast number of entities and in some unexpected circumstances, such as payments made by or to a partnership or trust of a MNE, payments to a foreign branch of a related party, US-parented Australian subsidiaries 'checked open' for US tax purposes, direct foreign investments by Australian entities and to related party payments that could directly or indirectly fund another hybrid arrangement within the MNE group.
- The rules apply to inbound and outbound MNEs, are not subject to any *de minimis* rule, and can apply to third-party payments.
- The rules contain an interposed entity TIR which can deny deductions related party interest and derivative payments not subject to greater than 10% foreign tax.
- The rules contain a broad reaching 'imported mismatch rule' which can deny deductions for group payments that indirectly or directly fund a mismatch elsewhere in the global group. This rule can apply to transactions which are not commercially connected.
- Taxpayers who are required to complete an International Dealings Schedule accompanying their income tax return are required to include a detailed Hybrid Mismatches Schedule.

Accordingly, it is prudent for Australian taxpayers that fall within the scope of the HMR to **continuously monitor and self-assess** their compliance with these rules to ensure relevant tax risks and exposures are appropriately managed.

In more detail...

Division 832 includes the following types of hybrid mismatch arrangements:

D/NI mismatches: financial instruments and payments by or to hybrid entities

D/D mismatches: payments by hybrid entities and branches

Imported mismatches: payments that are taxable overseas but directly or indirectly fund a hybrid mismatch elsewhere

Targeted integrity rule: interest or derivative payments taxed at 10% or less

For payments that are deductible for Australian tax purposes, a D/NI mismatch broadly arises where the amount of the payment that is the relevant deduction exceeds the amount of the payment that is ‘subject to foreign income tax’[1]. An amount is regarded as ‘subject to foreign income tax’ if, broadly:

- Foreign income tax is payable under a law of a foreign country in respect of the amount because the amount is included in the tax base of that law for the foreign tax period. In this regard, an amount is still considered subject to foreign income tax if the relevant entity’s tax base is nil or negative; or
- The amount is included in working out the tax base of another entity (e.g. a controlling shareholder) under a provision of a law of a foreign country that corresponds to Australia’s operative CFC provisions (including a tax base that is nil or negative)[2].

For payments that are deductible for Australian tax purposes, a D/D mismatch broadly arises if that payment also gives rise to a ‘foreign income tax deduction’, which is an amount of a loss or outgoing that an entity is entitled to deduct in working out its tax base under a foreign law.

For the purposes of Division 832, withholding type taxes, credit absorption taxes and unitary taxes are disregarded. Amendments passed in 2020 clarify that for federal income tax countries, state-based income taxes would also be disregarded, other than for TIR purposes.

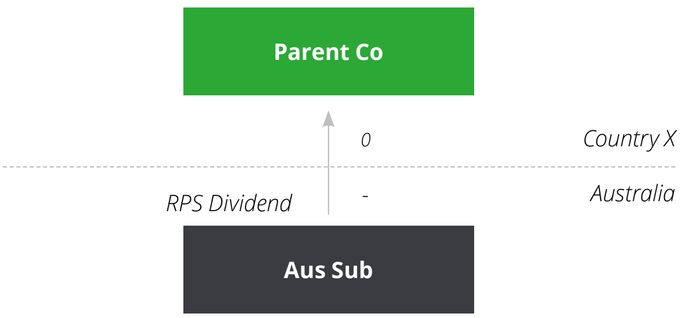
Types of D/NI mismatches

Hybrid Financial Instrument (HFI) mismatch (Subdivision 832-C)

A HFI mismatch can arise in relation to a financial arrangement that is a debt interest, an equity interest, a derivative financial arrangement, or a transfer of one of these types of financial arrangements (e.g. a repo or similar arrangement).

A return under a financial arrangement that is deductible may not be taxable in the hands of the recipient for a number of reasons. The HFI mismatch rule only applies if the mismatch is attributable to a difference in the treatment of the arrangement that arises because of the terms of the interest. For example, redeemable preference shares (RPS), which are be treated as debt for Australian tax purposes but as equity in the hands of a foreign shareholder may give rise to a dividend payment that is a D/NI mismatch (see Figure 1). This would generally be a HFI mismatch if the D/NI mismatch is attributable to the different countries’ characterisation of the RPS, based on the terms[3].

Figure 1: HFI Mismatch



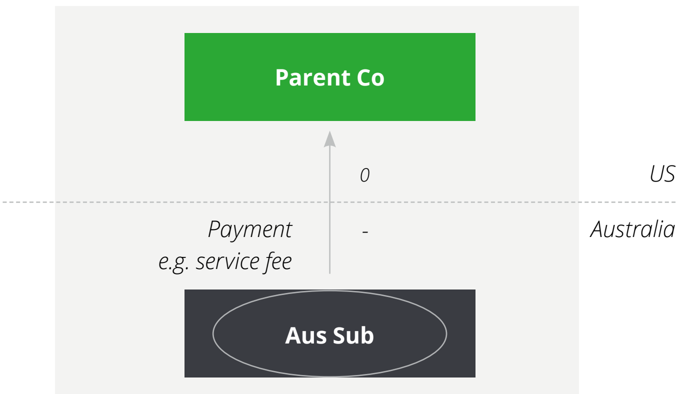
1. Within the same or a consecutive overlapping 12 month foreign income tax period.
2. Only the net amount included under the corresponding CFC regime is regarded as subject to foreign income tax.
3. Note, many countries, including Australia, have implemented amendments to deny participation exemptions on equity distributions that are deductible to a foreign subsidiary. Hence, the incidence of HFI mismatches in an Australian inbound context is expected to be minimal.

Hybrid payer mismatch (Subdivision 832-D)
The hybrid payer mismatch rule can apply to all types of deductible payments (e.g. interest, royalties, service fees, COGS).

A D/NI mismatch arises where a payment is made by an entity that is a 'hybrid payer', and the payment is disregarded in the hands of the recipient because it is treated as grouped with the hybrid payer. An example of a cross border arrangement of this type is a payment made by an Australian subsidiary to its US parent, where a 'check the box' election has been made for US tax purposes to treat the subsidiary as a disregarded entity (see Figure 2). Similarly, payments between members of an Australian tax consolidated group that are disregarded because of the single entity rule can give rise to hybrid payer D/NI mismatches.

In the case of a hybrid payer, a deduction will only be denied to the extent that the payments exceed the entities 'dual inclusion income'[4]. This is broadly an amount that is treated as subject to tax in Australia and a foreign country. However, the dual inclusion income rules are complex and as they are reliant on the actual facts surrounding a particular arrangement, should be carefully analysed if used to mitigate hybrid payer mismatch outcomes[5].

Figure 2: Hybrid Payer Mismatch



Reverse hybrid mismatch (Subdivision 832-E)
The reverse hybrid mismatch can apply to all types of deductible payments (e.g. interest, royalties, service fees, COGS).

A D/NI mismatch arises where a deductible payment is made to a reverse hybrid entity. A 'reverse hybrid entity' is an entity that is treated as transparent in its country of establishment, but as opaque in the country where the ultimate investor is liable to tax[6]. An example of a reverse hybrid entity is a foreign partnership that is 'checked closed' for US tax purposes.

A payment to a reverse hybrid entity that is a D/NI will be permanently denied, as there are no adjustments for dual inclusion income or any potential taxation of the amounts that may be distributed by the reverse hybrid in a future period. However, amounts included under a foreign controlled foreign company (CFC) regime may mitigate against the amount denied. This does, however, require careful analysis of whether the foreign CFC rule corresponds to Australia's operative CFC provisions, and adequate evidence of the amount included[7].

Branch hybrid mismatch (Subdivision 832-F)
The branch hybrid mismatch can apply to all types of deductible payments (e.g. interest, royalties, service fees, COGS).

A D/NI mismatch arises where a deductible payment is made to the foreign branch of another entity. A 'branch hybrid' arises where the branch country does not subject the payment to tax on the basis that it regards the payment as being made to the parent directly, whilst the parent allocates the payment to the branch country and accordingly exempts it from tax.

A payment to a branch hybrid entity that is a D/NI will be permanently denied, as there are no adjustments for dual inclusion income.

4. Deductions which are denied under the hybrid payer or deducting hybrid rule may be effectively 'revived' in a later year of income if the entity has excess dual inclusion income in a future year.
5. Amendments passed in 2020 clarified the application of dual inclusion income in certain circumstances.
6. The 'ultimate investor' could be the direct or indirect holder of the interests in the reverse hybrid entity.
7. Note the Commissioner's draft guidance that the US GILTI does not 'correspond', and hence would not mitigate a denial in the typical reverse hybrid scenario – see draft Taxation Determination 2019/D12.

Types of D/D mismatches

Deducting hybrid mismatch (Subdivision 832-G)

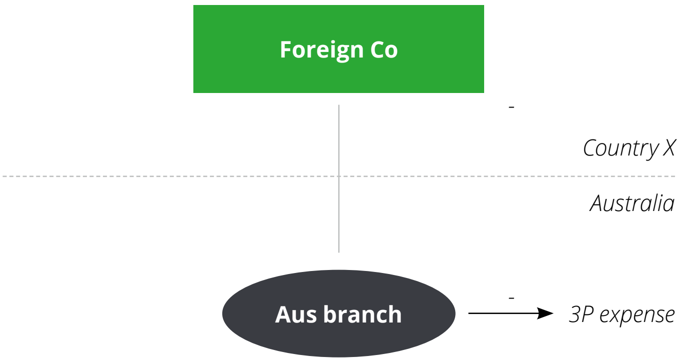
The deducting hybrid mismatch may apply to all types of deductible payments, as well as depreciation expenses and partnership losses. This mismatch involves D/D outcomes, whether these arise from related-party transactions or third-party payments.

Broadly, this mismatch may occur when an entity is able to deduct a payment in both jurisdictions.

An example of a deducting hybrid mismatch is a third party external payment made by an Australian subsidiary of a US parent that is 'checked open' for US tax purposes (similar to Figure 2). Another example is an Australian branch of a foreign entity, which is taxed on a worldwide basis (see Figure 3).

In the case of a deducting hybrid, a deduction will be denied to the extent that the payments exceed the entities 'dual inclusion income'[8]. This is broadly an amount that is treated as subject to tax in Australia and a foreign country. However, the dual inclusion income rules are complex and as they are reliant on the actual facts surrounding a particular arrangement, should be carefully analysed when used to mitigate D/D mismatch outcomes.

Figure 3: Deducting Hybrid Mismatch



Imported mismatches

Imported hybrid mismatch (Subdivision 832-H)

The imported mismatch applies to all types of deductible payments which do not give rise to a D/NI or D/D mismatch, although they directly or indirectly fund a D/NI or D/D mismatch. This integrity provision could have wide reaching consequences if a MNE group has hybrid mismatch arrangements anywhere in the group.

The imported mismatch rule applies to 'structured arrangements' and 'control groups'. However, the application of the rule only begins 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.

For income years beginning between 1 January 2019 and 31 December 2019, MNEs should focus on any payments that are made under a scheme where a D/NI or D/D mismatch was priced into the terms of an instrument, or a 'design feature' of the scheme[9]. There is limited guidance on what this means, although the concept is extremely broad. Furthermore, for income years beginning on or after 1 January 2020, all related party payments to countries other than those which have implemented "corresponding" foreign hybrid mismatch rules should be reviewed to ensure compliance with the imported mismatch rule, regardless of whether they are made under a 'structured arrangement'.

The imported mismatch rule is extremely broad reaching and the ATO has issued practical guidance outlining the Commissioner's expectations in terms of information gathering and reasonable enquiries for the purposes of sustaining a deduction for cross-border expenditure to related parties.

Broadly, Practical Compliance Guideline (PCG) 2021/5 sets a very high bar for compliance and includes a risk assessment framework for taxpayers to observe in complying with the imported mismatch rule. High risk arrangements are likely to be disclosable to the ATO in a Reportable Tax Positions schedule.

8. Deductions which are denied under the hybrid payer or deducting hybrid rule may be effectively 'revived' in a later year of income if the entity has excess dual inclusion income in a future year.
9. The Commissioner's view of this is contained in Practical Compliance Guideline 2019/6.

Integrity Rule

Targeted Integrity Rule (TIR) (Subdivision 832-J)

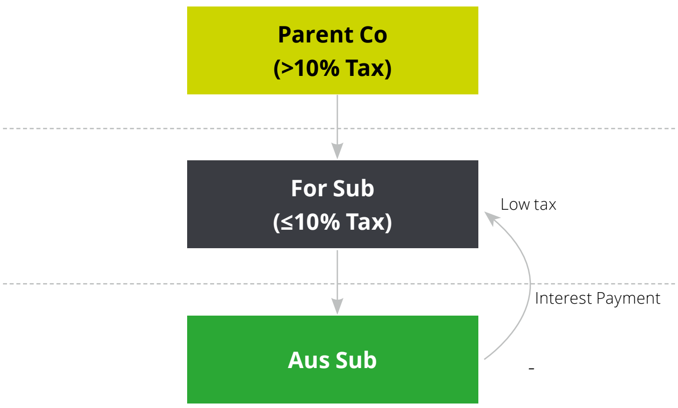
The TIR applies to interest or payments under derivative contracts among foreign-controlled groups. Broadly, the TIR seeks to deny an Australian deduction where an outgoing payment is subject to foreign tax at 10% or less.

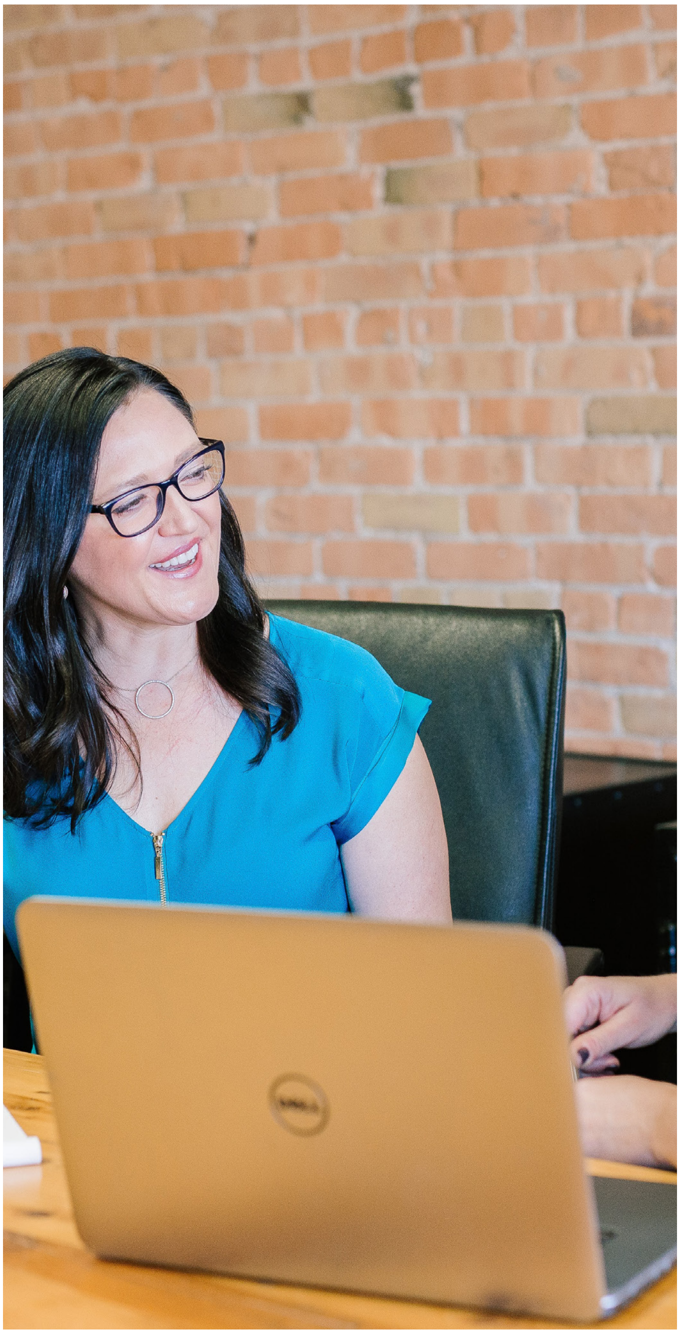
Several conditions must apply for the TIR to operate:

01. There is an interest payment or payment under a derivative financial arrangement, paid to a foreign interposed entity;
02. There is a foreign 'ultimate parent entity'[10];
03. The paying entity, the interposed entity and the ultimate parent entity are within the same control group;
04. The highest rate of foreign income tax paid (excluding withholding taxes) on the payments is 10% or less;
05. The payment is not subject to Australian income tax; and
06. The scheme under which the payment was made was entered into for the principal purpose of enabling the deduction and the low foreign income tax outcome.

There are certain exceptions to the TIR, for example if a foreign CFC regime operates to attribute 100% of the payment, or if the ultimate parent entity would have been subject to the same or a lesser rate of tax if it had received the interest directly. These exceptions are based on the specific facts surrounding an arrangement and should be reviewed carefully if relied upon.

Figure 4: Targeted Integrity Rule





10. The ultimate parent entity may be any type of entity, including a company, partnership, trust, individual or body politic. It is the entity that is not controlled by any other entity, unless that controller is outside the Division 832 control group.

Other measures introduced as part of the hybrid mismatch rules

Non-portfolio dividend exemption amendment

Subdivision 768-A of the ITAA 1997 treats a foreign equity distribution as non-assessable, non-exempt income if an Australian company holds at least a 10% participation interest in the foreign company. Changes were made to Subdivision 768-A in connection with the HMR to ensure that if an entity is entitled to a foreign income tax deduction in respect of the distribution, the exemption will not apply[11]. This amendment has effect for foreign equity distributions made on or after 1 January 2019.

Active foreign branch profits exemption amendment

Section 23AH of the Income Tax Assessment Act 1936 (**ITAA 1936**) exempts the foreign branch income of Australian companies, subject to certain limitations. The HMR amending Act modified the scope of section 23AH of the ITAA 1936 such that the exemption does not apply if the amount of income is a payment that gives rise to a branch hybrid mismatch. As outlined above, this type of arrangement broadly involves a payment being made to the branch and giving rise to a D/NI mismatch (i.e. deductible to the payer and not subject to tax in either the branch country or Australia).

Deductible/frankable distributions

The franking rules in section 207-158 of the ITAA 1997 were amended to deny imputation benefits for shareholders (i.e. franking credit gross-up and offset) on distributions made on or after 1 January 2019 on certain AT1 instruments where all or part of the distribution gives rise to a foreign income tax deduction. These arrangements typically affect AT1 capital issued by ADIs and insurance companies where the AT1 is attributable to a foreign branch.

Amendments passed in 2020 provide provide an exception to the denial of imputation benefits in certain circumstances, so that distributions may continue to be franked if the company includes an amount equal to the foreign income tax deduction in its assessable income. This exception will apply for ADIs and insurance companies, and as a condition to qualify for the exception the company must notify the Commissioner of Taxation that it or any other entity will not claim the foreign income tax deduction.

Foreign bank branches

Part IIIB of the ITAA 1936, which provides rules for foreign banks in working out the taxable income referable to their Australian branches, was modified to deny deductions for notional payments that would not be subject to tax in the foreign bank's country of residence.

11. Exceptions apply for certain collective investment vehicles, and in relation to payments between CFCs that are resident of the same foreign country.

ATO guidance on the rules

Guidance on hybrid mismatch concepts

- LCR 2019/3 *OECD hybrid mismatch rules – concept of structured arrangement.* This Law Companion ruling provides the ATO's view in relation to what a 'structured arrangement' is, and how an entity can be 'party' to a structured arrangement.
- PCG 2019/6 *OECD hybrid mismatch rules – concept of structured arrangement*. This Practical Compliance Guideline assists taxpayers in self-assessing their risk under the HMRs – particularly in relation to 'structured arrangements'.
- LCR 2021/1 *OECD hybrid mismatch rule - targeted integrity rule*. This ruling provides the Commissioner's view for interpreting the TIR under Subdivision 832-J.
- Draft TD 2019/D12 regarding section 951A of the US Internal Revenue Code. This draft determination provides that the US global intangible low taxed income (GILTI) rule does not correspond to Australia's operative CFC provision, and hence does not give rise to an amount regarded as subject to foreign income tax for the purposes of the HMR.
- PCG 2021/5 *Imported hybrid mismatch rule - ATO's compliance approach*. This guideline sets out the ATO's compliance and risk assessment approach regarding hybrid mismatches addressed by Subdivision 832-H.

Interaction with other laws

- The ATO published PCG 2018/7 in October 2018. This guideline sets out the ATO's compliance approach regarding Australia's general anti-avoidance rule (Part IVA of the ITAA 1936) and how this interacts with the HMR.

Deloitte Tax Insights articles for more information

Please see our **Deloitte Tax Insights** publications for more explanations of the hybrid mismatch rules:

- 16 December 2021 - Imported hybrids mismatches - Final ATO guidance released

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