CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006 Australia

GPO Box 2820 Melbourne
VIC 3001 Australia

T 1300 737 373
Outside Aust +613 9606 9677
cpaaustralia.com.au

19 February 2020

Manager
Corporate and International Tax Division
Treasury
Langton Cres
Parkes ACT 2600

By email: William.potts@treasury.gov.au

Dear William

Tax Integrity – Clarifying the Operation of the Hybrid Mismatch Rules

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

We make this submission on the *Treasury Laws Amendment (Measures for Consultation) Bill 2019: hybrid mismatch rules* (**the Exposure Draft**) to raise our concerns with the complexity and the application of these provisions to taxpayers in the small and medium enterprise (SME) sector.

We request that you consider the significant compliance burden imposed on SMEs and their advisors by these rules and the challenges in ensuring compliance in the SME and individual markets. We suggest that you consider a potential carveout for SMEs based on a deduction threshold (similar to the thin capitalisation rules).

Further details are contained in the Attachment.

If you have any queries, contact Elinor Kasapidis, Tax Policy Adviser, at elinor.kasapidis@cpaaustralia.com.au or 03 9606 9666.

Yours sincerely

Dr Gary Pflugrath CPA

Executive General Manager, Policy and Advocacy
CPA Australia

Encl.

Attachment

Increased compliance burden

The explanatory materials to the Exposure Draft explicitly outline that the purpose of the provisions is to target unfair tax advantages accruing to multinational enterprises (MNEs)[1]. However, the provisions are extremely broad in their application and so also currently apply to ordinary commercial transactions entered into by individuals and their small businesses entities.

This is mainly due to the breadth of the deducting hybrid rules in Subdivision 832-G of the *Income Tax Assessment Act 1997* which can apply whether or not transactions are entered into between related parties (i.e. a Division 832 control group) or under structured arrangements where a hybrid mismatch is priced into or is a design feature of a transaction. In contrast to the other subdivisions in Division 832, the absence of a hybrid requirement in the deducting hybrid rules means that they apply to 'vanilla' transactions by ordinary entities where both the entity and the payment is viewed similarly by both relevant jurisdictions.

Further, the concept of 'dual inclusion income' means that the deducting hybrid rules are amongst the most complex of the rules to apply from a set of already extraordinarily complex rules.

We are concerned that the hybrid mismatch rules will impose a substantial compliance burden on advisors who otherwise do not service clients with complex cross-border arrangements. These new rules may now require consideration of how the deducting hybrid rules apply to relatively small-scale investments. For example, the holding of a single rental property in a foreign country by either an individual, company or trust requires the full application of Subdivision 832-G where rental expenses are both deductible in Australia and in the foreign jurisdiction.

We believe that the cost of the tax analysis required by advisors on the transactions, the costs of the ongoing compliance burden (e.g. to track deduction-deduction mismatches year-on-year), and the requirement for the advisor to be familiar with Australian hybrid mismatch rules and the relevant foreign jurisdiction's applicable tax laws (including their foreign hybrid mismatch rules, if any) would far exceed any revenue gain from the SME sector.

Carveout for SMEs

The cost of compliance for SMEs may far exceed the additional tax payable under the rules which effectively are only concerned with timing benefits given the ability to later utilise deductions denied under Subdivision 832-G. We therefore request that Treasury consider including a specific carve-out from the deducting hybrid rules for individuals and SMEs.

As SMEs operate through various vehicles (in an individual capacity, through trusts, partnerships or companies), limiting a carveout to certain types of entities would not be appropriate. Instead, we recommend that Treasury consider a carveout similar to that contained in the thin capitalisation rules (section 820-35). This provision would exclude a taxpayer where the entity (and their associates) have foreign deductions that are below a certain threshold for an income year (e.g. $2 million). This would ensure that only those taxpayers whose affairs give rise to material tax risks are required to comply with these complex rules. It would also be consistent with the comment contained in the explanatory material that the measures are targeted to MNEs.

[1] Paragraph 1.6 of the Explanatory Materials.

Other technical issues

The Exposure Draft does not address the following issues:

- In what circumstances (if any) will a trust or a self-managed superannuation fund be considered a liable entity in Australia and thus be able to be a deducting hybrid?
- The requirement to trace through trusts and partnerships to determine the amount of dual inclusion income that can be applied to reduce the amount of a deducting hybrid mismatch requires consideration of the extent to which an amount 'reasonably represents' an amount assessable to other entities that are not flow-through themselves. This leads to complexity in applying deductions at various levels of interposed entities, as well as unusual or inappropriate outcomes that reduce the amount considered to be dual inclusion income, given that only net amounts flow through trusts and partnerships.
- The impossibility in many cases in tracing through various layers of interposed entities where information is not available to a trust or partnership, even in a closely-held group context (i.e. where there are multiple advisors at different levels).
- The difficulty in applying the foreign income tax offset interaction in subsection 832-680(2) to individuals who do not pay a flat rate of tax resulting in a circular process whereby their tax rate may change once a deduction is denied under the deducting hybrid rules.
- The mechanism adopted by the main operative provision (i.e. section 832-530) being the denial of an Australian deduction. This means that for entities that are flow-through in Australia (i.e. trusts and partnerships) this affects all of its beneficial owners (i.e. beneficiaries and partners). This can have the potentially inappropriate result that the low-tax rates of some beneficiaries or partners, or their status as non-residents, result in a lesser amount of dual inclusion income, with a greater Australian tax liability to be borne by those beneficial owners that did not contribute to this outcome in the first place (and at high rates of Australian tax). Arguably, such a result is inequitable and would not arise if the beneficial owners directly incurred their share of the relevant expenses that gave rise to deduction/deduction mismatches and directly derived their share of the relevant amounts subject to tax in two jurisdictions.

We also encourage Treasury to consider the following:

- Finding solutions to the issues outlined above that makes compliance with the rules simple for interposed entities. This would alleviate the need to trace through multiple layers of entities, apply expenses at multiple levels and quantify the effect of the foreign income tax offset at the last leg in the chain. This may involve a deeming rule such that an amount of assessable income of a trust or partnership is considered subject to Australian tax at 30% (i.e. the corporate rate for passive investments).
- Ensuring that the rules do not discriminate between investments held directly, and those held indirectly, so that the dual inclusion income of a trust or partnership does not result in some taxpayers sharing the burden of a deducting hybrid mismatch disproportionately. A deeming rule as suggested above may help achieve such an outcome.

We acknowledge the intention to introduce a Bill before 30 June 2020 to provide certainty for taxpayers for the current income year. We therefore suggest that that a SME carve-out based on a threshold test is provided. This may alleviate the short-term need to resolve the above issues.