22nd December 2017

The Manager
Base Erosion and Profit Shifting Unit
Corporate Income Tax Division
Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: BEPS@treasury.gov.au

Dear Treasury

Implementing the OECD Hybrid Mismatch Rules

The Australian Financial Markets Association (AFMA) represents the interests of well over 100 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We are pleased to make a submission on the Exposure Draft and draft Explanatory Memorandum for the legislation to implement the OECD Hybrid Mismatch Rules in an Australian context. Many AFMA members, particularly those that operate as Approved Deposit-Taking Institutions (**ADIs**) operate in Australia through a permanent establishment as opposed to a separate legal entity. In this light, our comments below reflect both the provisions in the Exposure Draft and also the interaction with the proposed intra-entity branch hybrid rules.

Commencement – Income Years Starting On or After from Royal Assent

We note the effect of proposed Section 832-10 is that the Hybrid Mismatch Rules will have effect six months from the date of Royal Assent. This means that the Rules will in all likelihood commence application during an affected entity's income year.

We recommend that commencement of the hybrid mismatch rules be amended such that it applies to income years starting on or after from Royal Assent. In this regard, we note

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the comments in the OECD's 2015 Report on Neutralising the Effect of Hybrid Mismatch Arrangements states twice (in paragraphs 307 and 311) that the rules should commence "from the beginning of a taxpayer's accounting period" so as to "avoid unnecessary complication and the risk of double taxation." Amending the commencement timeframe in a manner consistent with the OECD Report will also align with the commencement to the equivalent provisions in New Zealand.

Determination of both the existence of a hybrid mismatch and also the appropriate application of the provisions to such a mismatch will be a significant project for AFMA members, as evidenced by experiences in implementing the provisions in other jurisdictions, such as the UK. Given the current lack of ATO guidance on how the Rules will apply, and a reasonable expectation that such guidance will not be issued until well into the six months post Royal Assent, it is appropriate that commencement of the Rules occurs in a manner consistent with that suggested by the OECD.

Commencement – Branch Mismatch Rules

We note the Media Release issued by the Treasurer on 24 November 2017 that accompanied the release of the Exposure Draft and draft Explanatory Memorandum. That Media Release refers to the OECD Report "Neutralising the Effects of Branch Mismatch Arrangements" and the recommendation of that report to ensure that instances of double non-taxation that arise by virtue of the differences in the tax treatment of intra-entity dealings be brought into line with the hybrid mismatch arrangements. Given the nature of our membership, we expect to actively consult with the Government as these measures are developed and refined to ensure that they are appropriate given the policy context and also co-ordinated both in terms of application and commencement with similar measures that are being developed in other jurisdictions.

Our concern is that, according to the Media Release, the commencement of the branch mismatch measures is the same as the general hybrid mismatch rules, that is, six months after Royal Assent for the Bill that implements the general rules. Given our expectation as to the complexity of the branch mismatch rules, it may be problematic pegging the commencement of these rules to the timing of the general rules. Rather, we propose that the Government allows the commencement of the branch mismatch rules to also be six months after Royal Assent for the implementing Bill. This would allow affected entities the same opportunity to assess the implications for their corporate structures and undertake remedial action, where appropriate.

In this context, it is important to note that Australia is yet to adopt the approach adopted in the 2010 OECD Model Tax Convention in terms of treating branches as "functionally separate enterprises." Given the considerable number of other jurisdictions that have adopted the authorised OECD approach, and the lack of any Government recommendation that Australia may follow suit, a critical issue in consultation on the branch mismatch rules will be the extent to which a mismatch may arise merely by virtue

of Australia's failure to adopt the authorised OECD approach. This may be a catalyst for the Government to revisit its stance on the manner in which branches are taxed in Australia.

Thin Capitalisation and Withholding Tax Interaction

It is noted that under proposed Subdivision 832-B, where a hybrid mismatch arises in either a deduction/non-inclusion context, the hybrid mismatch may be neutralised by denying the deduction in Australia. To the extent that this represents a payment, we seek further clarity as to:

(i) Whether the instrument on which the payment was made and the deduction denied may be characterised as "debt" under Division 974 of the *Income Tax Assessment Act* 1997 where it was characterised as debt prior to the application of Subdivision 832-B, given the instrument does not give rise to debt deductions; and

(ii) Whether the payment is still "interest" for the purposes of applying interest withholding tax.

On this latter point, it is noted that, under Part IIIB of the *Income Tax Assessment Act* 1936, an amount that exceeds the "LIBOR Cap" and is treated as non-deductible for tax purposes is also not considered to be interest for the purpose of determining whether interest withholding tax applies. To the extent that interest withholding tax was to apply in respect of a payment for which a deduction will be denied under Division 832, the effect of the Division is more than neutralisation of the hybrid mismatch, which is inappropriate from a policy perspective.

Effect of Section 160ZZW Deeming Rule

Under Section 160ZZW of the *Income Tax Assessment Act* 1936, an Australian branch of a foreign bank that has not elected out of Part IIIB will be deemed to be a separate legal entity for the transactions to which Part IIIB applies. It is not clear from the Exposure Draft whether this deeming extends to the application of proposed Division 832, such that an Australian branch of a foreign bank is treated as a separate entity. This point ought to be clarified in the Exposure Draft and, depending on the nature of the clarification, the interaction between proposed Division 832 and the branch mismatch rules as they apply to Australian branches of foreign banks will need to be resolved.

Subject to Foreign Income Tax

Proposed Section 832-945(2) provides an exception to an amount being "subject to foreign income tax" where the entity is entitled under the law of the foreign country to a credit, rebate or other tax concession. This seems to imply that where relief from foreign tax is granted through provision of a foreign tax credit (as opposed to an exemption) then the payment that is subject to Division 832 will not be considered to be "subject to foreign

tax" and will not be considered to be dual inclusion income. In particular, we are concerned that in instances where a branch pays an amount to head office and head office is taxed on worldwide income but receives a credit for foreign taxes paid, then the existence of the foreign tax credit will prevent any payments from the branch from being considered to be subject for foreign tax and hence a deduction will be denied in Australia.

This provision appears to be contrary to the stance of both the OECD and the Board of Tax, both of which state that double tax relief should not prevent an item from being dual inclusion income. The policy basis and application for this provision in the context of double tax relief should be clarified.

Deduction/Non-Inclusion Mismatch

Under proposed Section 832-920, a payment from an Australian entity will give rise to a deduction/non-inclusion mismatch where the payment gives rise to an Australian tax deduction and the amount of the deduction exceeds the amount subject to foreign tax. We are of the view that the definition of "subject to foreign income tax" should be drafted in a manner that is sufficiently broad to allow for circumstances where the payment is reasonably attributable to the derivation of assessable income in the foreign jurisdiction.

Additional Tier-1 Regulatory Capital

The commencement date of Division 832 as it applies to Additional Tier-1 Capital instruments that were issued prior to 9 May 2017 where the instrument is "callable" is the first call date post 9 May 2017. Our view is that the grandfathering should only apply from the date six months after Royal Assent, such that if there is a call date on an Additional Tier-1 Capital instrument between 9 May 2017 and the commencement date, the effect of Division 832 should only apply to the later time. Secondly, in determining whether, and when, an instrument is "callable," regard needs to be had to whether APRA, or an equivalent prudential regulator, would permit such a call to occur.

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Thank you for the opportunity to make a submission and we look forward to further consultation on the branch hybrid mismatch rules. We would be happy to discuss any of the matters that we have raised in this submission. Please contact me on (02) 9776 7996 or rcolquhoun@afma.com.au .

Yours sincerely,

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Director, Policy