ATO proposes hybrid rules guidance

April 23, 2021

In brief

Australia’s hybrid mismatch rules include ‘imported mismatch’ rules, which may apply more broadly than OECD BEPS Action 2-compliant hybrid rules implemented in other countries. On April 21, the Australian Taxation Office (ATO) released a draft practical compliance guideline (PCG 2021/D3), which provides guidance on how taxpayers practically should apply the imported mismatch rule and what documentation is required.

The PCG provides guidance for taxpayers grappling with these rules in a self-assessment environment, but sets a high bar in terms of the information and documentation required to substantiate Australian deductions. The PCG details the level of supporting information the Commissioner expects taxpayers to obtain prior to filing income tax returns and to sustain deductions for payments to offshore related parties.

The takeaway: The draft PCG guidance will be important for taxpayers to consider, particularly for those preparing income tax returns for the second operational year of the Australian hybrid mismatch rules (e.g., years ended December 31, 2020 or ending June 30, 2021). Taxpayers are invited to provide comments by May 21.

In detail

Overview of the imported hybrid mismatch rules

Australia’s imported mismatch rules are contained in Subdivision 832-H of the Income Tax Assessment Act (ITAA) 1997. They generally are designed to implement recommendation 8 of the OECD Action 2 Final Report, as well as recommendation 5 of the Branch Mismatch Arrangements Report. The rules operate to disallow Australian deductions for payments - including payments for interest, royalties, rent, and purchases of goods or services - if the income from the payment is offset, directly or indirectly, against a deduction that arises under an offshore hybrid mismatch.

Importantly, Australia’s imported mismatch does not require a direct link between the Australian deduction and the offshore hybrid mismatch (an indirect link is sufficient), or for the Australian deduction to arise under a scheme or designed plan.
**Observation:** As a result, applying these rules in practice can be difficult since Australian taxpayers must make judgments about the operation of foreign tax laws and foreign transactions where the information may be imperfect. The imported mismatch rules operate under the presumption that the Australian taxpayer has perfect knowledge of the overseas group structure, relevant foreign tax law, and the flow of payments through the global group structure, notwithstanding that this ‘tracing’ exercise arguably may involve payments that have no direct or commercial link to payments made by the Australian entity. These complexities make the rules difficult to apply in practice.

**Observation:** In practice, this tracing rule typically goes further than other countries that have adopted OECD-compliant rules. The ATO acknowledges that the rules may create a compliance obligation for taxpayers, but suggests that taxpayers should be able to comply because the rule is limited to arrangements within members of the same group, or arrangements that are considered structured arrangements.

In PCG 2021/D3, the ATO also suggests that one way to reduce the compliance burdens under this measure is to eliminate all hybrid mismatch arrangements within the group. Immediately after this comment, the PCG references another PCG that sets out the Commissioner’s approach to applying Australia’s general anti-avoidance rules to certain restructurings to remove hybrids. Moreover, for US-headquartered companies, it may not be possible to eliminate all offshore hybrid mismatches given the common business use of entity-classification elections and potential non-Australian tax and commercial costs that would be incurred to redesign their business practices.

**ATO’s compliance approach and taxpayers’ obligations**

The draft PCG details the Commissioner’s expectations for how taxpayers are to meet their obligations under the law, and how the Commissioner will approach compliance activity with respect to these rules. The Commissioner believes that taxpayers should not deduct a payment to an offshore related party unless and until they have sufficient information from the global group to conclude that the payment deduction is not disallowed under the Australian imported hybrid mismatch rule.

Some of ATO’s expectations of taxpayers, and their associated compliance approach, as set out in the draft PCG are summarized below:

- **When must this analysis be done?**
  
  The Australian entity should document its inquiries and obtain the information prior to filing the income tax return. This documentation should be ready to provide to the Commissioner within a reasonable time of a request.

  The draft PCG explicitly suggests that if a taxpayer has not completed this analysis, or received the necessary information, by the time of lodging its income tax return, then it should prepare their return based on a denial of the Australian deduction. Subsequently, it can amend its return to take the deduction if the analysis has been prepared.

- **What information is the Australian taxpayer expected to have access to?**
  
  The Commissioner expects that regardless of whether or not the hybrid mismatch is structured, the Australian taxpayer should have ready access to all of the necessary information to undertake the assessment. In this respect, the Commissioner expects that the taxpayer’s foreign affiliates will provide ‘full and complete disclosure’ of ‘all relevant information’ to the Australian entity.

- **What documentation is expected?**
  
  In connection with gathering information from foreign affiliates, the Commissioner expects that the taxpayer should document formal requests for information from affiliated companies and the associated responses. The Commissioner expects that taxpayers should document the basis for any conclusion that the hybrid mismatch rules do not apply. This documentation will be required to achieve low and lower risk ratings under the risk assessment framework described below.
• **Who is responsible for this process?**

The draft PCG introduces the concept of ‘appropriately qualified responsible individuals’ and ‘suitably qualified representatives.’ The ATO’s recommended approach requires the taxpayer to make requests to responsible individuals or suitably qualified responsible individuals and suggests that this must include the person primarily responsible for the group’s tax obligations, such as the group head of tax. It also may include other individuals, such as country or regional tax managers, representatives of finance and treasury teams, and, for Australian-outbound groups, the public officer for the relevant entities.

• **How should taxpayers undertake this process?**

The ATO suggests that taxpayers can gain assurance either by a ‘top-down’ approach — where the group determines whether it has any hybrid mismatch outcomes globally — or a ‘bottom-up’ approach — where taxpayers determine whether any payments made by Australia, directly or indirectly, fund an offshore hybrid mismatch.

The PCG provides further comments regarding the nature of the information that should be included in a detailed appendix.

**Risk assessment framework**

The PCG includes a complex ‘traffic light’ style risk rating involving eight categories that are based on a number of factors, including the materiality of related-party payments and compliance with the ATO’s recommended approach to making reasonable inquiries.

<table>
<thead>
<tr>
<th>Risk Zone</th>
<th>Risk Level</th>
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<tbody>
<tr>
<td>White</td>
<td>Self-assessment of risk rating not necessary</td>
</tr>
<tr>
<td>Green</td>
<td>Low risk</td>
</tr>
<tr>
<td>Blue</td>
<td>Low-moderate risk</td>
</tr>
<tr>
<td>Yellow</td>
<td>Moderate risk</td>
</tr>
<tr>
<td>Amber</td>
<td>Moderate-high risk</td>
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<tr>
<td>Red 1</td>
<td>High risk</td>
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<td>Red 2</td>
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<tr>
<td>Red 3</td>
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A taxpayer can disclose a ‘green’ or ‘low risk’ rating only where it:

- demonstrates there are no offshore mismatches, or that all offshore mismatches have been neutralized by either Australia or a foreign country’s hybrid mismatch rules, or
- has not sought to claim deductions for payments made to members of the Division 832 control group.

Some taxpayers may be required to report this PCG risk rating on the Reportable Tax Position Schedule, which is filed with their annual income tax return. This risk rating also could be requested as part of the tax risk assessment undertaken during future Foreign Investment Review Board (FIRB) processes.
**Observation:** The impact of this will depend on various factors, including the timing of the final PCG. Therefore, it remains unclear if tax returns for the year ended December 31, 2020 will be impacted.

**Nature of this guidance**

Practical compliance guidelines are not prepared for the primary purpose of interpreting the way a tax law provision applies and are not public rulings. Therefore, the PCG does not provide guidance related to any of the challenging interpretative issues associated with the imported hybrid mismatch rules and taxpayers are expected to adopt their own positions on these issues.

For example, an important and potentially contentious issue is what countries may be considered to have corresponding foreign hybrid mismatch rules, including countries in the EU and the United States have adopted certain rules dealing with hybrid mismatches. This may impact the existence of an offshore hybrid mismatch under the top-down approach, as well as the tracing that may be required under the bottom-up approach.

**The takeaway**

Australia’s imported mismatch rules can apply to a broad range of taxpayers, and can apply even where there is no Australian tax planning involved. In order to substantiate Australian deductions (including interest, royalties, and purchases of goods and services), MNCs should consider the hybrid mismatch rules.

Accordingly, all taxpayers making cross-border related-party payments will need to consider the draft PCG and the potential work necessary to meet the proposed ATO requirements prior to filing their Australian tax return. This likely will require significant involvement from tax departments in the parent entity jurisdiction, up to and including involvement by the group head of tax.

Although these ATO requirements are not required by law, taxpayers should consider the consequences of not meeting ATO expectations, including the tax return disclosures that may be required (after the PCG is finalized), the impact on penalties in the event a tax shortfall later is identified, and potentially the impact on FIRB approval processes.

Finally, the PCG is still in draft, and affected taxpayers are invited to provide comments by May 21.
Let's talk

For a deeper discussion of how these draft guidelines might affect your business, please contact:

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