INTERESTING ASPECTS OF SOME NEW INTERNATIONAL TAX SCENARIOS

Why I find these scenarios "interesting", is that the level of complexity of the answers to the questions is confounding even to the experienced tax professional. The first scenario concerning discretionary trusts reflects the problem that arises when layer upon layer of amendments were effected over many years so that policy intention becomes impossible to discern (A1 below). The three other scenarios (B1-3 below) all involve the relatively new anti-hybrid provisions, that may be another high-water mark in obscurity of Australian tax law.

A1. *Obiter* that non-resident trust could have Australian CGT on non-TAP sold offshore

1. The Full Federal Court in *Peter Greensill Family Co Pty Ltd (Trustee) v Commissioner of Taxation* [2021] FCAFC 99 (10 June 2021)[1] found that Lex Greensill was assessable in relation to a capital gain to which he was specifically entitled, made by a resident trust, from the disposal of non-taxable Australian property ("non-TAP"). It was not in dispute that had he owned the non-taxable Australian property[2] directly, he would not have been assessable to Australian tax (s855-10). His argument was that the statutory provisions should be read to achieve the same result, as he said this was the policy of the legislation[3]. His greatest problem was that holders of units in a "fixed trust" are expressly entitled to the same treatment as individual owners (s855-40), and the Court accepted that this was a choice made by the legislature to give that treatment, which could have also been given expressly in the case of a discretionary trust, but it was not, at [63]. The *ratio* of the case was expressed in conclusion at [78]:

> "Thawley and Steward JJ were correct to hold that s 855-10(1) has no application to the facts of either case. The provision did not apply to the trustees of the respective trusts because both trusts are <u>resident trusts</u>. Likewise, the provision did not apply to the foreign beneficiaries to disregard any capital gain in the calculation of the amount under s 115-215(3) treated as the beneficiary's capital gain for the purposes of the application of div 102 to the beneficiary, because "the amount mentioned in s 115-

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[1] Being an appeal from *Peter Greensill Family Co Pty Ltd (trustee) v Commissioner of Taxation* [2020] FCA 559*; and N & M Holdings Pty Ltd v Commissioner of Taxation* [2020] FCA 1186, heard together.
[2] Indeed, the non-TAP were shares in an Australian company that was not land-rich, rather than in a non-resident company.
[3] At [69]. On 21 Aug 2020 Greenwoods with HSF in an article on the decisions at first instance, "Capital gains of foreign residents, again" wrote: "statutory interpretation – it is disappointing that the Federal Court was unable to interpret the statute in a way which produced the right outcome."

225 in relation to the beneficiary" for the purposes of s 115-215(3) and s 115-220 is not a "capital gain … from a CGT event" within the meaning of s 855-10."

2. However, in order to gain a coherent understanding of how the provisions worked, the Court also examined the position of a non-resident presently entitled beneficiary of a non-resident trust, which made a capital gain on non-TAP. Their comments on those facts therefore, were *obiter*.

3. Their *obiter* (at [24], [71]), was that the exemption for non-resident trusts from CGT on disposal of non-TAP happens by the application of the exemption in s855-10 at the first stage of the method statement in s102-5. The *obiter* was consistent with the Commissioner's binding tax ruling TD 2017/23.

4. An application for special leave to the High Court has not yet been heard. One would have thought now that five Federal Court judges including one that is now on the High Court, have all decided consistently, that the taxpayer was properly assessed, the prospects of being granted leave is remote[4].

5. However, in response to a submission from the Commissioner, the Court said if it was wrong on the *obiter* point, all that would mean was that the non-resident trust would be subject to CGT on the disposal of non-TAP, and that the source of the gain was not relevant[5]!

6. It would be bizarre indeed, if a non-resident trust with non-Australian situs assets could become liable to Australian CGT on the disposal of foreign asset pursuant to a contract entered into offshore with no Australian involvement, but that is the purport of what the Court said if it was wrong on its *obiter* point. Perhaps the unstated assumption by the Court was that the sale of shares would be in an Australian company with the further assumption that the source of the gain would therefore be Australia? The later assumption doesn't seem likely at least in relation to Div 115-C as the Court dismisses the relevance of source in that sub-division, at [72]-[73].

7. How would that ATO enforce the tax liability unless the non-resident trust had Australian assets? What would be the effect of any relevant DTA?

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[4] Even the High Court might need to get out their dictionaries so that they can understand what the Full Federal Court said when they used words like "epexegetical" at [11], "cavilled" at [13], [15]," conterminous" at [15], [73], and "gainsaid" at [52].

[5] At [71] extracted below. Perhaps you might call it a "double *obiter*" point.

8. The answer seems to be that where the non-resident beneficiary of a non-resident trust is presently entitled to a capital gain made by the trust on non-TAP, that s98(2A) does not require the trustee to withhold[6]. However, if the trustee accumulates the capital gain, s99A(4B) applies to tax the trustee, and unlike where the trust is a resident taxed under s99A(4A), the non-resident beneficiary who receives a distribution from that source, subsequent to the year of income, may not apply for a refund of the tax under s99D. In the case of each of s98, 99A and 99D the source concept[7] is relevant[8].

9. So, if the *obiter* was wrong, the Court's alternative is still leaving a situation where the trustee of the non-resident trust that accumulates the income, would bear Australian tax, even if the gain is not Australian sourced.

10. Normally Australian domestic tax law is based on some nexus with Australia. For example, the sale of shares in a chain of offshore companies may still attract Australian CGT if there is the adequate traced interest in Australian land: Div 855. As was pointed out in Damien Lockie's paper "Actual v Deemed – The edge of tax reality", 30 April 2013, Australia's Commonwealth Parliament has Constitutional power to assert its jurisdiction as it sees fit, but there will always be the question of whether the Parliament intended extra-territorial application, absent express words.

11. Australia's post 1988 DTAs expressly preserve Australia's right to tax capital gains under its domestic law, so those DTAs won't help e.g. China DTA Art 13(5). Only some DTAs recognize trusts as covered by the DTA. The China DTA recognises trusts at least in some contexts: Art 7(9). In relation to pre-CGT DTAs, the Courts ultimately held that capital gains on shares were "business profits" dealt with under the "business profits" articles of the pre-CGT DTAs (*Virgin*

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[6] Assessment of the non-resident beneficiary only takes place under s98A, if s98 has applied, allowing a deduction for tax assessed to the trustee.

[7] The definition of TAP is a "proxy" for source.

[8] A literal reading of *Greensill* might lead the reader to think that Div 115-C actually accesses all capital gains (see for instance at [10]), but see the headings & references in ss115-220 & 115-222 to s98 and ss99 & 99A respectively. It is true that s115-215 assesses presently entitled beneficiaries directly (effectively under s6-10 statutory income), and takes it out of s97. What Div 115-C generally does is calculate the quantum of a capital gain. Div 6E takes capital gains out of the Div 6 net income, but does not make Div 6 irrelevant: [4] at bottom of page 4 quoting from Thawley J: "Division 6E does not affect a trustee's liability under Div 6 as affected by the application of Subdiv 115-C." That is ss 98, 99 & 99A still are the assessment provisions where they would otherwise have applied: The Commissioner adopts that position in TD 2019/D7 at [14]. The Income Tax Rates Act 1986 does not specify rates of tax for Div 115-C as an assessing provision. Sections 98, 99 & 99A assessable amounts then include the Div 115-C calculated capital gain (and franked dividends), plus the residual s95 income ("Div 6E net income"-everything other than capital gains and franked dividends).

Holdings (2008); *Undershaft* (2009)), with the effect that if the non-resident did not have a PE in Australia, the "business profits" article would preclude Australian assessment.

12. In any event, taxpayers can rely on TD 2017/23 while it continues. The ATO would have no motivation to change it as the *obiter* is consistent with it.

13. The most relevant parts of the judgement are:

> "24.The assessable income of a trust estate includes any "net capital gain" made by the trust estate. The expression "net capital gain" has the meaning given by s 102-5 of the 1997 Act (see s 995-1 of the 1997 Act) and is the amount of a capital gain remaining after applying steps one to four of the method statement in s 102-5(1) of the 1997 Act. Step 1 is to reduce the capital gains made by the taxpayer in an income year by any capital losses that the taxpayer made in the income year. Step 2 is to apply any previously unapplied net losses from earlier years after the reduction of capital gains under Step 1. Where a taxpayer has discounted capital gains, Step 3 is to reduce each amount of a discount capital gain (remaining after Step 2, if any) by the discount percentage. Step 4 is to apply any small business concessions (if applicable). Step 5 is to add up the amounts of capital gains remaining after Step 4. The sum is the taxpayer's net capital gain for the income year and by s 102-5(1), the taxpayer's assessable income for that year includes that net capital gain. Whilst not argued by either of the parties, for the purposes of construing the statutory provisions, it is necessary to consider the extent to which the residency hypothesis applies in undertaking these steps. It seems to us that the residency hypothesis for the purposes of the calculation of a trust estate's s 95 net income has no application in the determination of whether a trust estate has made a net capital gain (calculated in accordance with s 102-5) for inclusion in the trust estate's assessable income. There are two reasons. First, it is evident from "Note 2" to Step 1 (which states that some provisions of the 1997 Act permit or require a taxpayer to disregard certain capital gains or losses when working out that taxpayer's net capital gain) that s 855-10 is intended to have operation at Step 1. Secondly, it is not the capital gain which is the assessable income of a taxpayer, but the net capital gain calculated in accordance with s 102-5. On that construction, s 855-10 applies to a foreign trust which has made a gain from non-taxable Australian property in computing whether it has a net capital gain for inclusion in its assessable income to be taken into account in working out its s 95 net income. For clarity, that gain is not is not the deemed capital gain worked out

under sub-div 115-C. For the reasons elaborated on later in these reasons, we have rejected the appellants' construction of s 855-10 and have concluded that the courts below were correct to hold that the deemed capital gain worked out under sub-div 115-C is not a capital gain to which s 855-10 applies.

"71. Another contextual argument was that the effect of the *Greensill* judgment is that s 855-10 operates within the calculation of a trust estate's s 95 net income, overriding the statutory hypothesis that the trustee (and trust estate) is a resident in order to calculate the net income of the trust estate. The Commissioner's response to this argument was that the interaction between s 855-10 and the definition of "net income" in s 95 was a false issue in these appeals, because neither appeal involves a foreign trust. That response was unhelpful because, in our view, whether and how s 855-10 operates within s 115-210 is part of the construction matrix as to how div 855 interacts with sub-div 115-C. At [24] of these reasons, we set out our view that the residency hypothesis does not apply in ascertaining whether a foreign trust estate has a net capital gain for an income year and, thus, in determining whether the precondition in s 115-210 for sub-div 115-C to apply is met in relation to the foreign trust. If this be correct, s 855-10 then has work to do. Otherwise, if the residency hypothesis applies at the point in time of determining whether a foreign trust estate has a net capital gain, s 855-10 has no work to do in relation to a foreign trust estate yet, plainly, that was Parliament's intention. But even if we are wrong about this and the residency hypothesis does apply at the point in time of determining whether a foreign trust estate has a net capital gain, that does not advance the appellants' construction of s 855-10, because all it means is that the precondition for the application of sub-div 115-C will have been met, albeit that the net capital gain of the foreign trust is from a CGT event happening to a CGT asset that is non-taxable Australian property. The operative provisions of sub-div 115-C would then apply to bring that net capital gain to tax."

14. In relation to the submission about whether the gain was sourced in Australia, the court said:

"72. Mr Robertson QC's primary contention that sub-div 115-C does not assess a foreign taxpayer on amounts that would not be div 6 assessable income – which he termed "non-Australian gains" – and that s 855-10 and its predecessors plainly inform what is assessable under div 6-does not withstand scrutiny.

"73. First, the contention assumes or asserts that there is no difference between, on the one hand, a CGT asset being taxable Australian property and, on the other, a capital gain from a CGT event that happens to that CGT asset having an Australian source, however they are not coterminous. Division 855 contains a set of rules for determining when a CGT asset is taxable Australian property and, in the case of shares in a company, as is the case here, it depends on the nature and value of the underlying property held by the company, including through interposed entities: ss 855-25, 855-30, 855-32. In contrast, whether a gain has an Australian source depends on a different factual enquiry, which involves a wide variety of factors which may vary from case to case: see *Federal Commissioner of Taxation v Resource Capital Fund IV LP* (2019) 266 FCR 1; [2019] FCAFC 51 at 19-22 [59]–[66], 68 [230]. Neither Court below made a finding to the effect that the capital gains is this Court in a position to resolve that factual question, which, it may be anticipated, would have involved the calling of other evidence below, if the submission had been made."

15. Another issue of interest is that the judgement says that the capital gain made by the trustee is a different thing from capital gains made by beneficiaries i.e. what the beneficiary gets is only "attributed" to the trustee's capital gain[9]. In effect the trustee makes the nominal capital gain but what the beneficiary is assessed on is a number which started with the nominal capital gain, reduced by the trust's losses, and may then be halved and halved again[10] (and in the process doesn't wholly retain its character as a capital gain)[11] CF *Charles*'s case [1954] HCA 16 at [11], usually cited as authority for the proposition that "a trust's capital gain retains its character in the hands of the beneficiary"[12], albeit in that case the trust was a unit trust where the unit

[9] Reference to capital gain "attributed" at [7], [8], [10],[42].

[10] And then grossed up again in the hands of the beneficiary, before applying the beneficiary's capital losses, then potentially halved and halved again. What is assessed in the beneficiary's hands may only bear some resemblance to the nominal gain in the trustee's hands.

[11] See [6(b)], [6(c)], [14(c)], although [35] says the number includes an "extra capital gain". Certainly, the Commissioner's position is that the gain does not retain its character under s99B: TD 2017/23 & 24.

[12] In the Greenwoods' article at footnote 3 above: "The notion that the tax position of a beneficiary is to be determined as if they had earned the income themselves has been clear since the High Court's decision in *Charles* in the 1950s, it underpinned the Board of Taxation's work on MITs and collective investment vehicles, and was enacted by Parliament when it legislated the Investment Manager Regime and the Attribution MIT rules."

holders had an interest in the trust property[13]. That what the beneficiary gets is more a "number" rather than a capital gain[14], has a parallel with the argument as to why some Courts have said DTAs don't limit the application of the CFC provisions because the CFC attributable income does not retain its character, but is just an "arithmetic calculation": see my 24 July 2012 paper entitled "Russell's case, Sommerer's case, and CFC Treaty Override". See:

http://robertgordontax.com/documents/articles/Russell 's case, Sommerer 's case, and CFC Treaty Override.pdf

16. Before leaving the topic of *Greensill*, it must be said that the ATO's "Highlights of the Tax Avoidance Taskforce contribution for 2020–21" include:

"We continue to identify and address taxpayers deliberately entering abusive trust arrangements. The current coverage of both the *Greensill* and *Martin* matters highlights where we seek to prevent the exploitation of tax loopholes by high next wealth individuals and groups."

17. It is not obvious from the reported decisions how what happened in those cases are "abusive trust arrangements" which "exploit tax loopholes". There was no suggestion that Part IVA or s100A[15] was relevant. Lex Greensill was a beneficiary of his brother's family trust. Is the ATO suggesting that an Australian resident family trust can't distribute to a real non-resident beneficiary family member? It might be different if the beneficiary was not a family member and there was a reimbursement arrangement. Based on the decision of all five judges of Federal Court, there was no "tax loophole".

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[13] The position appears to be different when the unit holder does not have an interest in the trust property: *CPT Custodian Pty Ltd v FC of T* [2005] HCA 53 at [33]-[36].

[14] Summarising what Thawley J said, FFC at [6] on page 11: "(d) the result of the calculation required by s 115-225(1) is simply an amount which the statute requires to be calculated. It is not a capital gain capable of being the subject of s 855-10(1)".

[15] On which the ATO has been working for an eternity to issue a draft ruling, now due for early 2022.

B. The Anti-Hybrid Rules

1. To give some context for those who are not familiar with the Rules in Div 832, I quote from the EM which introduced the Bill in 2018, with some cross-references:

> "1.26 These rules will prevent entities (including multinational corporations) that are liable to income tax in Australia from being able to avoid income taxation, or obtain a double non-taxation benefit, by exploiting differences between the tax treatment of entities and instruments across different countries.
>
> 1.27 The rules implement the recommendations in the OECD Action 2 Report, taking into account the recommendations made by the Board of Taxation.
>
> 1.28 Broadly, a hybrid mismatch will arise if:
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> - an entity enters into a scheme that gives rise to a payment; and
> - the payment gives rise to:
>   - – a deduction/non-inclusion mismatch; or
>   - – a deduction/deduction mismatch.
>
> [1.10….
>
> • A deduction/deduction mismatch occurs when a business receives a deduction in two countries for the same payment.
>
> • A deduction/non-inclusion mismatch occurs when a deduction is provided for a payment in one country, but the corresponding income is not included as assessable income in the recipient country.]
>
> 1.29 A mismatch will be covered by the hybrid mismatch rules if it is:
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> - a hybrid financial instrument mismatch; [Div 832-C, counters deduction/non-inclusion mismatches]

- a hybrid payer[16] mismatch; [Div 832-D, counters deduction/non-inclusion mismatches]
- a reverse hybrid[17] mismatch; [Div 832-E, counters deduction/non-inclusion mismatches]
- a branch hybrid[18] mismatch; [Div 832-F, counters deduction/non-inclusion mismatches]
- a deducting hybrid[19] mismatch; [Div 832-G, counters deduction/deduction mismatches] or
- an imported hybrid mismatch[20] [Div 832-H].

[1.11 A simple example of a deduction/non-inclusion hybrid mismatch is a financial instrument that is treated as:

- debt in one country, providing the issuer with a deduction for any interest paid; and
- equity in another country, providing the holder with an exemption for any dividends or returns received from the other country.]

1.30 If a mismatch arises, it is neutralised by:

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[16] An entity is a hybrid payer if a payment it makes is disregarded for the purposes of the tax law of one country (resulting in non-inclusion), but is deductible for the purposes of the tax law of another country.

[17]An entity is a reverse hybrid if it is transparent for the purposes of the tax law of the country in which it is formed, but non-transparent for the purposes of the tax law of the country in which investors in it are subject to tax (resulting in non-inclusion).

[18] An entity is a branch hybrid in relation to a payment made to it if, for the purposes of the tax law of the country in which it is a resident, the payment is treated as being allocated to a permanent establishment in another country, but in the other country, the payment is treated as *not* being allocated to a permanent establishment in that country.

[19] An entity is a deducting hybrid if a payment it makes is deductible for the purposes of the tax law of 2 countries.

[20] An imported hybrid mismatch is an integrity rule that applies when one or more entities are interposed between a hybrid mismatch and a country that has hybrid mismatch rules.

- disallowing a deduction[21]; or
- including an amount in assessable income[22].

[1.118 The way that a hybrid mismatch is neutralised depends on the type of mismatch. However, where there is a neutralising amount for a hybrid payer mismatch or a deducting hybrid mismatch, the amount of the mismatch can be reduced by dual inclusion income. [s 832-675]

1.119 An amount of income or profits is ***dual inclusion income*** if two or more of the following outcomes arise for the amount:

- it is subject to Australian income tax in an income year;
- it is subject to foreign income tax in a foreign country in a foreign tax period; or
- it is subject to foreign income tax in another foreign country in a foreign tax period.

[s832-680(1) and the definition of 'dual inclusion income' in subsection 995-1(1)]]

1.31 A targeted integrity rule will prevent the effect of the hybrid mismatch rules to neutralise double non-taxation outcomes from being compromised by multinational groups using interposed country conduit type vehicles to invest into Australia, as an alternative to investing into Australia using hybrid instruments or entities." [Div 832-J]

[21] This is usually the "primary response" e.g. re Div 832-C, see EM [1.172-3], re Div 832-D, see EM [1.215-6]. It applies in the country of the payer. If the payer country has hybrid mismatch rules equivalent to Australia, then the payer country will deny the deduction and to avoid double taxation, Australia does not apply its hybrid mismatch rules. Confusingly however, under Div 832-G (Deducting Hybrid), as both countries are disallowing otherwise available deductions, there are rules to say which country should disallow a deduction, being the "primary response country" or the "secondary response country".

[22] This is usually the "secondary response" (called the "defensive response" in the OECD Report). It applies in Australia as the recipient country, if the payer country does not have hybrid mismatch rules equivalent to Australia, which disallow the deduction in the recipient country.

2. At the same time, provisions were introduced to:

> • deny imputation benefits on franked distributions made by an Australian corporate tax entity if all or part of the distribution gives rise to a foreign income tax deduction; [s207-145(1)(db); s207-150(1)(eb); s207-158]; and
>
> • prevent certain foreign equity distributions received, directly or indirectly, by an Australian corporate tax entity from being non assessable non-exempt income if all or part of the distribution gives rise to a foreign income tax deduction. [s768-7]

3. There are no reported cases on the hybrid mismatch rules in Australia yet. It is impossible to know, but some of the cases before the introduction of Div 832 exhibited facts which may have indicated the existence of a hybrid mismatch e.g. In *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 the Full Federal Court noted at [19] that the US subsidiary of CAHPL did not pay tax in the US without explaining why (referring back to [126], [147] of the original decision [2015] FCA 1092).

4. *Commissioner of Taxation v Noza Holdings Pty Ltd* [2012] FCAFC 43 appears to display a number of aspects of hybrid mismatch. From the appeal and first instance decision ([2011] FCA 46) it appears that the preference shares issued by CSA (Australia) to CSF (US) were treated as debt by Australia giving rising to a s25-90 deduction (whilst CSA was treated as a branch of CSF in the US [42] of decision at first instance). Further, the foreign source income justifying the s25-90 deduction was a s23AJ non-assessable non-exempt dividend paid on preference shares by SGTS (US) to AFC in Australia, which was equity for Australian purposes but debt for US purposes. (Noza was the head entity of a MEC group including CSA and AFC, so the income and expenses of group members were accounted for by Noza).

5. As of last week, the OECD's website says:

> "Since announcement of the Action 2 recommendations, a number of Inclusive Framework countries have rapidly adopted rules to address a comprehensive range of hybrid and branch mismatches. The United Kingdom, Australia and New Zealand have enacted legislation consistent with the common approach in Action 2 and, in 2019 the US Treasury issued regulations clarifying the application of the hybrid mismatch rules

introduced under the Tax Cuts and Jobs Act. European Union Member States adopted Council Directive (EU) 2017/952 which requires hybrid and branch mismatch rules to be effective in member states no later than the beginning of 2020."

6. Scenarios B1-3 all involve potential denial of deductions in Australia as a primary response country, rather than inclusion of income as a secondary response country.

B1. Anti-Hybrid rules denying deductions for Australian owned corporate dual resident SMEs

1. The changed interpretation of the corporate tax residence rules in TR 2018/5 (and PCG 2018/9) following the High Court decision in *Bywater Investments Limited & Ors v. Commissioner of Taxation* [2016] HCA 45 are more likely to make many more Australian controlled foreign companies, tax residents of Australia.

2. Where those foreign companies sell goods or services to their Australian parent company, the 2020 Budget announcement that foreign companies with their CM&C in Australia will only be Australian tax residents if they have "core commercial activities in Australia", may still cause them a problem if those sales to the parent are such "core commercial activities in Australia".

3. Page 5 of the Board of Taxation's Corporate Tax Residency Reform Options paper (Dec 2019) provided examples of flow-on consequences within the income tax legislation if the revised ATO approach resulted in foreign companies becoming Australia tax residents, but did not mention Div 832-G.

4. The original problem with the Deducting Hybrid Rules in Div 832-G introduced with effect for tax years starting from 1 Jan 2019, is that they applied even to individuals with foreign source income and deductions which both Australia and the foreign company allowed as deductions in calculating each countries tax liability i.e. a deduction/deduction mismatch. This was criticized by Prof. Graeme Cooper in the Taxation Specialist, "The curious reform of foreign source income", August 2018.

5. Div 832-G, unlike most of the other anti-hybrid rules, does not require the payment to be to a member of a Div 832 Control Group or a "structured payment".

6. This problem for individuals was alleviated by amendments to the Deducting Hybrid Rules in Aug 2020 (with retrospective effect). However, whilst the EM to the Bill that introduced the legislation says the amendments confined the operation of the Rules to companies, but also alleviated the problem for “certain small business entities and trusts”, at [1.50], this actually isn’t cross referenced to Small Business Entities (SBEs) as defined in Div 328.

7. Where a foreign company that is taken to be an Australian tax resident, and it is a dual resident, which is treated by Australia as though the foreign company had a foreign branch, and s23AH exempts the income of the foreign company, there will not be a problem with the Deducting Hybrid Rules.

8. However, it is not uncommon for the foreign company to exist for the convenience of the group to buy goods overseas and on-sell them to the Australian parent e.g. for European VAT reasons. Unless the foreign company’s directors or employees undertake manufacture on those goods before sale to the Australian parent, the foreign company will effectively have the equivalent of “tainted sales income” that is not NANE under s23AH.

9. I say there is still effectively the equivalent of an attribution problem for the “tainted sales income” in this case, as the offshore company as an Australian resident is selling goods to an Australian resident associate, and the legislation effectively assumes this must be Australian source income (s23AH only exempts foreign income).

10. That effective equivalent of “tainted sales income” in the hands of the deemed Australian resident company will be assessable income and associated deductions will be deductible in Australia and if also in the foreign company, the foreign company is a Deducting Hybrid.

11. To the extent that the foreign company has borne foreign tax on the effective equivalent of "tainted sales income", this will reduce the deductions available in Australia by the Deducting Hybrid Rules[23], where there is no tax mischief.

12. This should not have been a problem as it is presumably to be including the same items of its income in both the foreign country and Australia, and paying tax in both countries, which should have resulted in no application of the provisions due to s832-560, as the deduction/deduction mismatch should have been offset by the "dual inclusion income". However, as Prof. Cooper points out at pp 6-7, the problem comes from the amount being considered to be "subject to tax" in Australia being reduced by the FITO under s832-680. The result would be that there would be a reduction in the amounts that the foreign company could claim as deductions in determining its taxable income in Australia.

13. I note that the 2014 OECD BEPS Action Item 2, "Neutralising the Effects of Hybrid Mismatch Arrangements", recommendation for dual resident companies did not say anything about the foreign tax credit reducing the amount of foreign income that would be dual inclusion income "subject to tax". As noted by Cooper at p9, this was a deliberate deviation by Australia from the OECD position, which was in fact acknowledged in the EM that introduced the 2020 amending Bill.

B2. Common Asian family lending arrangement potentially caught by anti-hybrid rules to deny deductions for interest paid by Australian entities to non-resident lenders controlled by the family

1. Consider a family resident in Malaysia who have a family office in Singapore constituted by a Singapore resident company, which they have funded with equity and debt over the years.

[23] Note Australia will be a "primary response country" due to s832-555(2). If the other country of residence of the dual resident company has hybrid mismatch rules, there could be a deduction denied there as well, resulting in double taxation.

2. Say the Singapore resident company has lent funds to an Australian company to undertake property development in Australia.

3. Interest income of the Singapore company on funds lent to the Australian company is considered foreign source income in Singapore and is tax exempt in Singapore. However, it will bear Australian interest withholding tax of 10%.

4. Div 832-J (introduced effective for years of income commencing from 1 Jan 2019) was said in the EM to the Bill introducing the legislation, to be an "integrity measure" to protect against the deduction/non-inclusion mismatch targeted by the anti-hybrid rules, but the anti-hybrid rules target mismatches between the tax treatment of financial instruments in different countries, or the tax treatment of entities in different countries, not simply a differential in tax rates.

5. The reality of Div 832-J isn't that it provides "integrity" to Div 832, but that it is probably more a limited Diverted Profits Tax applying to interest deductions, in relation to entities who are nowhere near being "Significant Global Entities". It was not a recommendation of the OECD BEPS Action Item 2, and appears to have been "tacked onto" Div 832 in the guise that it protected that regime (and therefore subject to less scrutiny).

6. Div 832-J denies deductions for interest paid by an Australian company to a related non-resident associated company in circumstances where the related non-resident company does not bear foreign tax of at least 10%, and the funds have been lent to the intermediary company by the intermediary company's parent who would have paid tax at a rate of more than 10% if the interest had been received directly. The fact that Australian interest withholding tax of 10% will have already been paid, is ignored.

7. So, in the above case Div 832-J would not apply as Malaysia and Singapore both have a territorial tax system which means if the interest had been paid to Malaysia direct, it would not have borne tax at a higher rate.

8. However, Thailand taxes income on a world-wide basis and has a corporate tax rate of 20%, and no CFC rules. If the Thai company sets up a Singapore subsidiary[24] that receives the interest from a related company in Australia, Div 832-J will apply as the Singapore company pays less than 10% Singapore tax (in fact none as it is foreign source income from Singapore's perspective), and had the interest been paid to Thailand, it would have borne Thai tax of 20%.

B3. My 2016 TTI Paper

1. My April 2016 TTI paper" Increasing use of tax-transparent entities by private groups due to BEPS", didn't discuss the anti-hybrid provisions (which the government didn't announce would be adopted until the May 2016 Budget).

2. That paper was making the point that where the foreign tax was becoming significant in relation to privately owned groups, rather than maintaining tax deferral by interposed corporate entities between the foreign income and the Australian resident individual owners, and losing the benefit of the foreign tax credit (FITO), it might be better to do away with the corporate entities and the tax deferral, and earn the income so as to be taxed in the hands of the Australian resident individuals, with a full FITO, so that the world-wide tax would not exceed the top marginal rate in Australia[25]. See: http://robertgordontax.com/documents/articles/Increasing use of tax-transparent entities by private groups due to BEPS Robert Gordon.pdf

3. I want to test the two most common examples referred to in that paper, used to retain the benefit of the FITO, against the hybrid mismatch rules:

   (i) Australian resident discretionary trust (DT) carrying on business in one foreign country[26];

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[24] Div 832-J, unlike the other provisions of Div 832, requires a tax avoidance purpose: see LCR 2021/1.
[25] Where the foreign tax was 35%, the world-wide tax rate would be 68.5% if there was no FITO.
[26] and distributing its net income to Australian resident individuals who obtain the benefit of the FITO.

(ii) Australian resident DT being the sole member of a US LLC to derive foreign or US business income[27].

Example One

1. In relation to (i) above, I have confined the analysis to business income from one foreign country (e.g. NZ), as an Australian corporate trustee may not be an acceptable vehicle to carry on business further afield. I have also limited the analysis to business income and assuming the Australian corporate trustee will have a Permanent Establishment in that one foreign country.

2. It will often be the case that the foreign country will treat the DT (with a corporate trustee), as a corporate taxpayer. It may be that the trustee doesn't disclose it is a trustee. Other countries simply don't recognize the trust and tax the trustee as though it was the beneficial owner. NZ taxes the trustee of a discretionary trust at a 45% rate, which is creditable to a beneficiary on distribution.

3. The anti-hybrid rules are really only potentially engaged in this case, to disallow deductions in Australia, not to include income, as the income is already included, and in any event, will be coming from unrelated parties.

4. Before the Aug 2020 amendments, the DT would have been a Deducting Hybrid (Div 832-G) as was "liable" in at least one of those countries (i.e. in both), and it would have been deducting its expenses in both countries, but it will also be including the same income in both countries, so that the "neutralising amount" should have been zero, but for the FITO reduction of deductible amounts which was not then limited to corporate entities[28].

5. After the Aug 2020 amendments the problem with the FITO went away as it then became only relevant to corporate entities, but it also in any event ceased to be a Deducting Hybrid, because whilst it was "liable" in both countries it was not a tax

[27] ditto

[28] As NZ has hybrid mismatch rules, it would have been necessary to determine whether Australia or NZ was the "primary response country". If NZ was the "primary response country" then it would deny the deduction and Australia would not: s832-535(2).

resident of both (substituted s832-550(c)). It wasn't resident in the US for US purposes nor was it taxable in the US on its world-wide income (s832-555(9)).

6. Also, the DT won't be a Hybrid Payer (Div 832-D) as it won't be paying deductible expenses to a related entity (as a generalisation). By related entity, more specifically to a member of a Div 832 Control Group[29].

7. From the Australian perspective, it won't be a Reverse Hybrid (Div 832-E) as it isn't formed in the foreign country and disregarded for the purposes of the foreign country's tax law.

<u>Example Two</u>

1. In relation to (ii) above, this is more complicated as the US LLC is assumed to be carrying on business in the US and in third countries, so as to derive both foreign and US source business income, from a US perspective. In the US it will be treated as transparent (unless it elects not to be) and so its' member is the party liable to the US tax on the LLC's US source income. The US does not tax the foreign source income if the member of the LLC is a foreign resident. It is also assumed that the LLC does not have PEs in the third countries. The US LLC is much more widely recognized doing business in foreign countries than an Australia corporate trustee.

2. The US LLC will not be a Reverse Hybrid as although it is formed in the US and treated as a transparent entity there, but by virtue of Div 830 in Australia applying automatically to US LLCs, it won't be treated as a corporate taxpayer from the Australian perspective[30].

3. The US and foreign source income will be a taxed in the hands of the beneficiaries of the DT in Australia[31], and the hands of the DT in the US[32], only on the US source income (assumedly as a company). All of the DT's expenses will be deductible in Australia but only those referrable to the US source income will be deductible to it in the US. So, there is still a deduction/deduction mismatch, even though the deductions in Australia

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[29] or assuming the payment is part of a "Structured Arrangement": see LCR 2019/3 & PCG 2019/6.
[30] Interestingly, Div 830 refers to the US LLC as a "hybrid" but Div 832 calls it a "reverse hybrid".
[31] so that beneficiaries are the "liable" party in Australia.
[32] so that the DT is the "liable" party in the US.

are greater. Thus, the DT will be a Deducting Hybrid (Div 832-G) as it has expenses deductible in determining its US net income, and also deductible in determining the DT's net income in Australia. However, its dual inclusion income is both the US and foreign source income, so the dual inclusion income exceeds the dual deduction expenses, and so there is no denied deduction[33].

4. It won't be a Hybrid Payer as it won't be paying deductible expenses to a related entity (as a generalisation). By related entity, more specifically to a member of a Div 832 Control Group[34]. The US LLC will be in the Control Group as the DT will own 100% of the US LLC. Note the other way to be part of a Control Group is if consolidated financial accounts are required, but the DT is not a Reporting Entity for accounting standards purposes, and is not required to file accounts for the purposes of the Corporations Act. Further note that only the "transferor" with respect to the DT would have a "direct participation interest" (of 100%) in the DT, and would be part of the Div 832 Control Group (as the interests of the presently entitled beneficiaries would only be as discretionary objects).

Disclaimer

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[33] For the same reason as noted in Example One, after the Aug 2020 amendments, Div 832-G won't apply to the DT in Australia as a non-corporate entity. Before that, as the US has hybrid mismatch rules, it would have been necessary to determine whether Australia or the US was the "primary response country". If the US was the "primary response country" then it would deny the deduction and Australia would not: s832-535(2). The ATO is said to be working on guidance as to whether the US hybrid mismatch rules are equivalent to the Australian rules. So far, they have only issued limited guidance in TD 2019/D12 (in relation to s941A of the Code), but not in relation to ss 245A(e) and 267A of the Code.

[34] or assuming the payment is part of a "Structured Arrangement".