Deducting Hybrid Mismatch Rules – Fit for Purpose?

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The deducting hybrid mismatch rules in Subdiv 832G of the Income Tax Assessment Act 1997 (Cth) were purportedly introduced to combat tax avoidance by large multinational enterprises through duplication of deductions. Its effect is to quarantine certain tax losses. However, its scope, as originally enacted, was broad, with the unintended consequence of affecting many simple and small-scale cross-border transactions. A recent amendment has the effect of scaling down the scope of Subdiv 832G – but it also opens opportunities for tax avoidance. This article argues that both Subdiv 832G and the corresponding OECD recommendations in Action 2 of the BEPS Project wrongly target the hybrid structures as the mischief in question, leading to excessive taxation of economic profit, and that "loss duplication" is the real issue at hand. Consequently, it proposes further amendments under which a tax loss can only be used in either Australia or a foreign country, but not in both countries.

Introduction

The deducting hybrid mismatch rules, contained in Subdiv 832G of the *Income Tax Assessment Act 1997* (Cth), were introduced in 2018 off the back of the recommendations in the Organisation for Economic Cooperation and Development (OECD) reports for Action 2 of the BEPS Project – that is, the "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report" (OECD Action 2 Report)[1] and the "Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS" (OECD Branch Mismatch Arrangements Report)[2] (together, "OECD Reports"). The issues arising from hybrid mismatches that the OECD intended to address, as well as the corresponding tax policy considerations, were analysed in an earlier report – "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" – which paved the way for the 2015 Final Report on Action 2.[3]

As the OECD Reports reveal, there are many instances of tax avoidance arrangements implemented by multinational enterprises (MNEs), achieving duplication of deductions and tax losses by exploiting "differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions".[4] The OECD Reports concluded that deducting hybrid mismatch rules are necessary to combat such tax avoidance and to safeguard tax revenue.[5] As a result, the OECD recommendations have been adopted by many countries.[6]

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[1] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report" (2015) <https://www.oecd.org/tax/beps/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm> (OECD Action 2 Report).

[2] OECD, "Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS" (2017) <https://www.oecd.org/tax/beps/neutralising-the-effects-of-branch-mismatch-arrangements-action-2-9789264278790-en.htm>.

[3] OECD, "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (2012) <https://www.oecd.org/tax/beps/hybridmismatcharrangementstaxpolicyandcomplianceissues.htm>. Issues arising from hybrid mismatch arrangements were highlighted in earlier OECD reports, including OECD, "Addressing Tax Risks Involving Bank Losses" (2010) <https://www.oecd.org/tax/administration/46023583.pdf>; OECD, "Corporate Loss Utilisation Through Aggressive Tax Planning" (2011) <https://www.oecd.org/tax/exchange-of-tax-information/corporatelossutilisationthroughaggressivetaxplanning.htm>.

[4] OECD Action 2 Report, n 1, 11.

[5] See, eg, OECD Action 2 Report, n 1, 11.

[6] For an international comparison of the implementation of the hybrid mismatch rules, see Mark Brabazon, "Are We There Yet? International Implementation of Hybrid Mismatch Rules" (2019) 73 (6/7) *Bulletin for International Taxation* 304. See also Svea Holtmann, "Tax Avoidance Using Hybrid Financial Instruments Among European Countries" (2020) 2 *British Tax Review* 217.

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Closely following the release of the OECD Action 2 Report, the Australian Board of Taxation commenced consultation on the implementation of the OECD's recommendations on hybrid mismatches.[7] Five months later, the Board recommended that Australia should adopt largely the recommendations in the OECD Action 2 Report.[8] The resulting hybrid mismatch rules, which are highly complex, were enacted in 2018.[9]

This article focuses on the deducting hybrid mismatch rules contained in Subdiv 832G. These rules, which are intended to address the double deduction issues, adversely impact many common and traditional cross-border business and investment transactions, such as conducting a micro-business overseas or making an investment in a single rental apartment in a foreign country.

The article first argues that the effect of the deducting hybrid mismatch rules is to quarantine tax losses, as opposed to disallowing a deduction, as it may appear at first glance. This highlights the subject matter in question, facilitating the development of a desirable policy response to the mischief Subdiv 832G targets. It then analyses the recommendations of the OECD Reports with respect to the double deduction issues arising from hybrid mismatches, paving the way for the argument that because the emphasis of the deducting hybrid mismatch rules is placed on "hybrid structures" rather than on the root of the problem – being the access of the same loss in different countries (Separate Loss Utilisation) – implementation of the OECD recommendations may lead to over-taxation. After examining the scope of the deducting hybrid mismatch rules in their original form and as amended by the *Treasury Laws Amendment (2020 Measures No 2) Act 2020* (Cth) (*Amending Act*), the article argues that the scope of the original rules was too broad and capable of affecting the majority of common and traditional cross-border business and investment transactions, especially those carried on by non-corporate entities. While the *Amending Act* seems to narrow the scope of the original rules considerably, it opens opportunities for tax avoidance through Separate Loss Utilisation. The article proposes further amendments to the deducting hybrid mismatch rules, aiming to mitigate the undesirable impact on common cross-border business and investment activities and to address the Separate Loss Utilisation issue.

Effect of the Deducting Hybrid Mismatch Rules

At first glance, it appears that the deducting hybrid mismatch rules would operate to deny a deduction. However, on further examination, these rules effectively operate to quarantine a tax loss.

The operative provisions – s 832-530,[10] aided by s 832-560 – operate to deny an amount, not exceeding the "neutralising amount", following a three-step process, as described below incorporating an illustration:

(1) Identify a deduction[11] (the "Australian deduction") – for example, $100, which gives rise to the deduction component of a deduction/deduction mismatch[12] (D/D component).[13]
(2) Ascertain the lesser of the amount of each Australian deduction ($100) and foreign income deduction[14] (assuming $95), which appears to be the same amount of D/D component in Step 1. Therefore, the Step 2 amount is $95 in this illustration.[15] The excess of the Australian deduction

[7] Board of Taxation, "Implementation of the OECD Anti-Hybrid Rules – Consultation Paper" (Australian Government, 2015) <https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/08/BoT-Anti-hybrid-Discussion-Paper.pdf>. The Australian government seems to have decided to implement anti-hybrid rules even before the release of the OECD Action 2 Report, n 1, iv.

[8] Board of Taxation, "Implementation of the OECD Anti-Hybrid Rules – A Report to the Treasurer" (Australian Government, 2016) <https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2016/05/Implementation-of-the-OECD-hybrid-mismatch-rules.pdf>.

[9] *Treasury Laws Amendment (Tax Integrity and Other Measures No 2) Act 2018* (Cth).

[10] Unless otherwise stated, all sections are references to those of the *Income Tax Assessment Act 1997* (Cth).

[11] "Deduction", as defined in *Income Tax Assessment Act 1997* (Cth) s 995-1, means "an amount that you can deduct". "Deduct", as defined in *Income Tax Assessment Act 1997* (Cth) s 955-1, has the meaning given by ss 8-1, 8-5.

[12] Effectively the smaller amount of the Australian deduction and the foreign income deduction.

[13] *Income Tax Assessment Act 1997* (Cth) ss 832-530(1), 832-545(2), 832-110.

[14] *Income Tax Assessment Act 1997* (Cth) s 832-120.

[15] *Income Tax Assessment Act 1997* (Cth) s 832-560(1)(a).

over the foreign income deduction (ie $5) is relieved from the operation of the deducting hybrid mismatch rules and is deductible.

(3) Calculate neutralising amount:
   (a) the Step 2 amount (ie $95)
   (b) minus any dual inclusion income, which is the income/profit recognised in Australia and another foreign county,[16] implying the smaller amount of the Australian income inclusion and foreign income inclusion (assuming the Australian income inclusion is $70 while the foreign inclusion is $75, the dual inclusion income is $70).

Consequently, the neutralising amount is $25 (ie $95–$70). This amount is disallowed as a deduction under the deducting hybrid mismatch rules, leaving $75 deductible (ie $100–$25). To summarise, under the deducting hybrid mismatch rules, the tax loss is $5 (ie $70–$75), while without the introduction of the deducting hybrid mismatch rules there would be a tax loss of $30 (ie $70–$100) as determined under Div 36 (Normal Tax Loss). The difference is, of course, the neutralising amount of $25.

While the neutralising amount of $25 in the illustration above is less than the Normal Tax Loss, they are not different in nature. They are different in quantum because in calculating the neutralising amount the effect of foreign taxation is taken into consideration. This leads to a different amount to the Normal Tax Loss, which is determined only under Australian tax laws.

The effect of s 832-565 is to reduce the dual inclusion income derived in later years by the previously disallowed neutralising amount,[17] thereby leaving only the balance as assessable. To complete the above illustration, if assuming the later dual inclusion income is $60, reduced by the neutralising amount of $25, the taxable income in that later year is $35.

Consequently, the effect of the deducting hybrid mismatch rules is to isolate the D/D component to be deductible against dual inclusion income, whether derived in the current or a later income year. It follows that the essential effect of the deducting hybrid mismatch rules is to quarantine a tax loss.

Where Australia is a primary response country, from an Australian resident taxpayers' perspective, the dual inclusion income is foreign source income[18] in most circumstances. That is, the foreign source income of an Australian resident taxpayer is likely to be included in both Australian and foreign assessable income. Consequently, the deducting hybrid mismatch rules operate, in the majority of those cases, to quarantine foreign losses, in a manner reminiscent of the operation of former s 79D of the *Income Tax Assessment Act 1936* (Cth) (*ITAA 36*), repealed a decade ago.

The effect that the deducting hybrid mismatch rules operate to quarantine a tax loss is not surprising. A duplicated deduction is probably harmless, if there is a larger dual inclusion income derived by the same entity, producing a net profit, which is assessable in the relevant countries.

The effect of the deducting hybrid mismatch rules being to quarantine the tax loss rather than to disallow a deduction is not just a labelling issue. Correct and clear identification of the subject matter of Subdiv 832G would highlight the mischief in question, thereby assisting the development of a desirable policy response.

OECD Recommendations in Respect of the Deducting Hybrid Mismatch Rules

The Explanatory Memorandum (EM) to the *Treasury Laws Amendment (Tax Integrity and Other Measures No 2) Bill 2018* (Cth) states that the deducting hybrid mismatch rules were introduced to implement Recommendation 6 of the OECD Action 2 Report and Recommendation 4 of the OECD Branch Mismatch Arrangements Report.[19] It may have been more accurate for the EM to note Recommendation

[16] *Income Tax Assessment Act 1997* (Cth) s 832-680.

[17] Explanatory Memorandum, *Treasury Laws Amendment (Tax Integrity and Other Measures No 2) Bill 2018* (Cth) [1.318].

[18] There are exceptions, such as where Australian-sourced income of an Australian resident company can be attributed to a foreign taxpayer under the controlled foreign corporation rules of a foreign country, therefore being dual inclusion income.

[19] Explanatory Memorandum, *Treasury Laws Amendment (Tax Integrity and Other Measures No 2) Bill 2018* (Cth) [1.283].

7 of OECD Action 2 Report was also implemented, in respect of a dual resident entity[20] (this portion of the OECD Reports is compendiously referred to as the "OECD D/D Mismatch Reports").

Since the Australian deducting hybrid mismatch rules were implemented off the back of recommendations made by the OECD D/D Mismatch Reports, a discussion of those recommendations provides the backdrop for analysing the scope of Subdiv 832G in the next section.

The recommendations in the OECD D/D Mismatch Reports are summarised below (together, "OECD Recommendations"):

(1) The recommendations apply where there is an offending structure, being a hybrid entity, a branch[21] and/or a dual resident entity (Offending Structures).
(2) In the case of a dual resident entity, the loss will be quarantined in both countries.
(3) In the case of a hybrid entity, the country of the investor[22] (ie the owner/interest holder of a hybrid entity) will quarantine the loss (ie the duplicated deduction can only offset dual inclusion income and any excess can be carried forward to offset future dual inclusion income).
(4) In the case of a branch, the country of the head office of the branch will quarantine the loss (Branch Recommendation).
(5) A hybrid entity or a branch can freely deduct the duplicated deduction and use losses against any income (dual inclusion income or not). However, if the investor's country does not quarantine the loss, then the jurisdiction of the hybrid entity or branch should quarantine the loss – that is, these countries are to apply the secondary or defensive rules.

A "dual resident entity" is an entity that is a resident of two states for tax purposes.[23] A "branch" is not defined in the OECD Reports; it likely means a "permanent establishment" (PE), as defined by the OECD Model Tax Convention, of a head office in another country, the presence of which subjects the head office to tax in that country where the PE exists.

A "hybrid entity"[24] is an entity that is treated as a separate taxpayer (ie fiscally opaque) in its country of establishment, but as fiscally transparent under the laws of its investor. An Australian proprietary limited company (fiscally opaque in Australia) can be a hybrid entity, if the country of its shareholders treats it as a partnership or a disregarded entity (fiscally transparent), as is possible in the United States.[25] In terms of Australian outbound investment, a hybrid entity is relatively rare. One example[26] is two members of an Australian consolidated group forming a general partnership established in the United States (USGP), which is regarded as a partnership in Australia under s 995-1 and can be a subsidiary member of that consolidated group under s 703-15(2)(b) Item 2, thereby being fiscally transparent under Australian tax laws. The USGP elects to be treated as a corporation under *Treasury Regulations* (US) § 303-7701(3), promulgated under the *Internal Revenue Code of 1986* (US) (*IRC US*), thereby being fiscally opaque in the United States. Another example is if two Australian taxpayers form a partnership in a country where a partnership is treated as an entity which itself is liable for tax (such as in India).

It is clear that the OECD Recommendations do not take issue with a deduction recognised by both the source and resident countries of the same entity (though this was within the original scope of Australian deducting hybrid mismatch rules, as discussed below). They do, however, take issue with the same

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[20] See *Income Tax Assessment Act 1997* (Cth) s 832-555(2); OECD Action 2 Report, n 1, Ch 7.

[21] Within Recommendation 6 "Deductible hybrid payments rule" of the OECD Action 2 Report, n 1, the definition of "hybrid payer" includes both a branch and a hybrid entity. This article separates the two concepts as they are different – a branch is normally fiscally transparent, but a hybrid entity is transparent in one country but opaque in another country.

[22] "Investor", in relation to any person, means any person directly or indirectly holding voting rights or equity interests in that person, under Ch 12 "Other definitions" of the OECD Action 2 Report, n 1. There is no definition of "investor" in respect of a branch in the OECD Branch Mismatch Arrangements Report. "Investor" seems to mean the holding entity of a hybrid entity or the head office of a branch.

[23] OECD Action 2 Report, n 1, 12.

[24] OECD Action 2 Report, n 1, [124].

[25] *Treasury Regulations* (US) § 303-7701(3).

[26] Taxpayer Alert: ATO, *Cross-Border Round Robin Financing Arrangements*, TA 2016/10, 15 September 2016, Example 2.

deduction being recognised by two countries where both consider themselves the resident country of the same entity, or the same deduction is claimed by both a hybrid entity/branch and its investor (ie two separate groups of entity in two different countries). That is, the OECD Recommendations emphasise that the hybrid nature of Offending Structures is the cause of the mischief in question, which, as argued below, is misplaced.

Under the OECD Recommendations, tax losses of a dual resident entity are to be quarantined by both countries involved, which is justified by the OECD Action 2 Report on the basis that, because the deduction/loss recognised by two countries is being incurred by the same taxpayer, it is impossible to determine which country should deny the deduction/loss.[27] This seems to be a bit of a cop out. Obviously, the report could resolve this dilemma by making the recommendation to give a choice to the dual resident entity as to which country the deduction/loss is claimed in. The United States (US) dual consolidated rules, which are the genesis[28] of the OECD D/D Mismatch Reports, have featured such an election since 1989, when temporary *Treasury Regulations* were promulgated under s 1503(d) of the *IRC US*.[29]

The true reason, one suspects, for the non-inclusion of such an election in the OECD Recommendations is that a dual resident entity is regarded as a tax abusive structure, thus deserving little to no attention, or any special treatment. It is true that dual resident entities can and have been used to perpetuate tax avoidance, but there is no inherent evil in the creation of a dual resident entity structure. It can be a result of:

- oversight, particularly in the case of SMEs that have limited access to tax expertise, in which case the dual residence may be unintended, and can even result in a more burdensome tax liability for the entity;
- situations including genuine mergers of companies, globalisation or industry-specific business models (such as in funds management) and vertical management of groups;
- mergers among equals (such as the Reed Elsevier merger and Unilever and Royal Dutch Shell) or dual-listing companies that operate as one single business and have the same board of directors;
- regulatory constraints, such as where a company is incorporated in foreign country and used for local operations to get around tighter exchange control for foreign companies (ie the formation country differs to the country of central management and control or place of effective management); and
- the application of the US “anti-inversion” provisions, which continuously treats the expatriated company as a US domestic company, etc.[30]

Admittedly, while a dual resident entity can come into existence in innocuous circumstances, it does have features that can be used to facilitate tax avoidance through Separate Loss Utilisation – as illustrated in Example 1.

Example 1 – The Dual Resident Entity Loss

A company (DRco) is a subsidiary of HeadCo, which is the head company of a consolidated group in country X. Both companies were formed in country X, which determines a company’s residency solely on where that company is formed (as in the United States). DRco expanded into Australia, and its Australian business grew exponentially. This necessitated DRco relocating its “central management and control” to Australia, thereby becoming a dual resident company.[31] DRco formed an Australian consolidated group with its Australian subsidiary (SubAu), which was incorporated to conduct another line of business. After several years, the business of DRco has been in decline while SubAu’s has been booming. In year Y, HeadCo and SubAu each had profits of $100 while DRco had a loss of $100 from its trading.

If DRco’s loss was not quarantined as per OECD Recommendations, the loss would be used by both HeadCo and SubAu (ie Separate Loss Utilisation). Consequently, the tax profit of the group would be nil, while its economic profit, $100, completely escapes taxation.

[27] OECD Action 2 Report, n 1, [217].

[28] G Cooper, “The Curious Reform of Foreign Source Income” (2018) 22(1) *The Tax Specialist* 2, 6.

[29] *Internal Revenue Code of 1986* (US) § 1.1503-2T (g)(2) – TD 8434, 1992-2 CB 240, 244.

[30] G Maisto et al, “International-Dual Residence of Companies under Tax Treaties” (2018) 1(1) *International Tax Studies* [5.2.1].

[31] Tax Ruling: ATO, *Income Tax: Central Management and Control Test of Residency*, TR 2018/5, 21 June 2018.

The same outcome can also be achieved by using (collectively, "OECD Illustrations"):

(1) a hybrid entity – see example 6.3 and 6.5 of OECD Action 2 Report; and
(2) a branch – see example 6.2 of the OECD Action 2 Report and example 10 of the OECD Branch Mismatch Arrangements Report.
Continuing on from the facts in Example 1, if DRco's loss was quarantined, as per the OECD Recommendations, which were implemented by the Australian deducting hybrid mismatch rules, the net profit in the group would be $200 for tax purposes, while the economic profit is $100 – that is, the economic profit is excessively taxed.

In the authors' view, the optimal outcome is that DRco's loss should be either used by HeadCo, or offset against SubAu's profit, but not both. In either case, the group profit is $100 for tax purposes, in line with its economic profit. This optimal outcome is referred to as the "Desirable Policy Outcome".

As Example 1 demonstrates, the OECD Recommendations do not achieve the Desirable Policy Outcome. It follows that the Australian deducting hybrid mismatch rules based on them would also not achieve the Desirable Policy Outcome.

A careful examination of Example 1 and the OECD Illustrations reveals that the mischief is not the Offending Structures themselves but rather the situation where entities in two different countries access and utilise the same loss – that is, Separate Loss Utilisation.

Separate Loss Utilisation has long been recognised as a pivotal factor in literature in respect of the US dual consolidated loss (DCL) rules, which, as mentioned above, are the genesis of the OECD D/D Mismatch Reports. For example, in commenting on the then proposed *Treasury Regulations* promulgated under s 1503(d) of IRS US, the New York State Bar Association Tax Section stated:

> The dual consolidated loss rules are fundamentally concerned with "double dipping" – that is, using losses to reduce U.S. tax and then again using them to reduce the foreign taxes of *another foreign entity*.[32]

In order to achieve Separate Loss Utilisation, there are two indispensable elements:

(1) a hybrid structure, which produces a result where the same tax loss is recognised by two countries simultaneously; and
(2) a loss transfer mechanism, such as tax consolidation, group relief rules or a reversed hybrid entity, which enables the loss to be transferred to another entity.

The OECD D/D Mismatch Reports discuss three types of hybrid structures – namely, the dual resident entity, the hybrid entity and the branch (ie the Offending Structures). The common feature of the Offending Structures is their hybridity, in the sense that the relevant countries take different views as to their tax attributes. That is:

- In a case involving a dual resident entity, both of the relevant countries consider it as a resident in their jurisdictions.
- In a case involving a hybrid entity, the investor's country considers it as fiscally transparent, while the hybrid's country considers it as being its resident taxpayer (ie fiscally opaque).
- In a case involving a branch, the head office country considers the tax losses of the branch belong to the head office only, but the local jurisdiction of the branch considers the loss as transferable to another entity.

In the authors' view, neither hybrid structures nor the loss transfer mechanism in isolation are objectionable, but together they can be used to perpetuate tax avoidance through Separate Loss Utilisation. They are the means to achieve an end, but they are not the root of the problem. The root of the problem is Separate Loss Utilisation. Consequently, this article puts forward the following three important propositions, which underpin the theme of this article.

First, since the root of the problem is Separate Loss Utilisation, it should be dealt with directly, as discussed in greater detail below, through the making of a loss use election so that a tax loss can only be

[32] New York State Bar Association Tax Section, "Report on Proposed Dual Consolidated Loss Regulations Proposed Dual Consolidated Loss Regulations" (2005) [I.A.1] (emphasis added).

used in one country. This achieves the Desirable Policy Outcome where the tax profit is the same as the economic profit.

Second, a stand-alone Offending Structure should not be subject to the rules developed to combat Separate Loss Utilisation. This is because the loss transfer mechanism, which is an indispensable element to achieve Separate Loss Utilisation, requires the involvement of other entities in addition to the stand-alone Offending Structure. By itself, a stand-alone Offending Structure is harmless, as illustrated in Example 2.

Example 2 – Standalone Offending Structure Loss

- An Australian trust in year one has Australian source income of $100, which is offset by a $100 foreign loss produced by a wholly owned hybrid entity in a foreign country. The tax loss of this foreign hybrid entity is carried forward in the foreign country. If in year two or a later year the foreign hybrid entity produces a profit of $100, this carried forward loss can be used to offset the said profit in the foreign country but is assessable in Australia.
- There is no mischief, because the group members (ie the Australian trust and the foreign hybrid entity) have the same economic and taxable profit of nil in year one and $100 in year two, which is fully assessed in Australia. From the foreign country's perspective, where the only tax unit is the foreign hybrid entity, it has both a nil economic and a nil taxable profit.
- There is excessive taxation if the tax loss of the foreign hybrid entity is denied as a deduction in Australia, thereby subjecting the $100 produced by the Australian trust to tax in year one, while the group had nil economic profit in that year.
- However, there is tax mischief if the above scenario is altered so that under this foreign country's fiscal unit regime (eg tax consolidation or group relief rules), the $100 tax loss of the foreign hybrid entity in year one, can be transferred to, or otherwise accessed by, a subsidiary of the Australian trust in the foreign country, which has generated active income of $100. Alternatively, the foreign hybrid entity may acquire a reversed hybrid entity (ie it is fiscally transparent in that country but fiscally opaque in Australia), which has active income of $100.
- There is mischief because in year one this group has economic profits of $100 and nil taxable profit as a result of the tax loss of the foreign hybrid entity being separately used by another entity (ie the foreign subsidiary or the reversed foreign hybrid entity), in addition to the use of the tax loss by the Australian trust.

The analysis embodied in the above example also applies, with necessary modifications, to scenarios where a foreign branch or a dual resident entity is involved, instead of a foreign hybrid entity.

Stand-alone Offending Structures are more likely to be used by SMEs to carry out common and traditional cross-border business and investment transactions, without contemplating tax avoidance, rather than by MNEs, which use Offending Structures as part of elaborate arrangements designed to access Separate Loss Utilisation. Outright exclusion of stand-alone Offending Structures from the rules against Separate Loss Utilisation avoids inflicting unnecessary damage on SMEs, which may not even be aware of the existence of the loss transfer mechanisms (such as tax consolidation) of the relevant countries, or have no intention of using them (such as by forming a tax consolidation group).

Thirdly, even if an Offending Structure is deliberately put into place for the purpose of perpetuating tax avoidance through Separate Loss Utilisation, it is unnecessary to deny the loss deduction in both countries, thereby resulting in over-taxing the economic profit. The better approach is to limit the use of the tax loss to only one country.

Scope of Deducting Hybrid Mismatch Rules

The discussion of the OECD Recommendations above lays down the analytic foundation to assess the scope of the Australian deducting hybrid mismatch rules. The discussion does not suggest that Subdiv 832G should be set according to those recommendations, but provides context for understanding the scope of Subdiv 832G in both its original form and as amended by the *Amending Act*.

As discussed above, there are two elements required in order to achieve Separate Loss Utilisation: the first is the loss transfer mechanism; the second is an Offending Structure – the latter receiving great emphasis in the OECD D/D Mismatch Reports that underpin the OECD Recommendations.

Given that Subdiv 832G was implemented off the back of the OECD Recommendations, one would logically assume that the entity type subject to the deducting hybrid mismatch rules would have been the Offending Structures – however, this was not the case.

As originally enacted, the term "deducting hybrid" in s 832-550 described an entity that was subject to the deducting hybrid mismatch rules as including, inter alia, a "liable entity" in at least one deducting country. A "liable entity", as defined in s 832-325, broadly means an entity that is liable for tax in a country, in respect of the income or profits of its own or of another entity. Consequently, "deducting hybrid" was an extremely broad concept. The majority of entities (if not all of them) across the globe are subject to tax in a particular country and it follows that they would be regarded as a deducting hybrid if they incurred a tax deduction in that country. As such, under the original deducting hybrid mismatch rules, the type of entity that was a deducting hybrid was not limited to only the Offending Structures, as the OECD Recommendations suggested.

The other two key concepts of the deducting hybrid mismatch rules – the D/D component and the dual inclusion income – scaled down the scope of Subdiv 832G to only transactions with cross-border elements, by requiring deductions and income respectively to be simultaneously subject to the tax systems of two countries as a prerequisite for the rules to apply. Consequently, the deducting hybrid mismatch rules, in their original form, applied indiscriminately to quarantine tax losses, regardless whether they were generated from elaborate tax avoidance schemes or merely from common and traditional cross-border investment and business transactions, such as those in Example 3.

Example 3 – Losses from Simple and Small-Scale Cross-Border Commercial Activities

Such losses include:

- a micro-business carried on overseas by an Australian trust or individual (which might be subject to tax in a foreign country, because it either had a PE there or business income sourced in that country);
- investment in a rental apartment; or
- employment activities undertaken by an Australian resident on secondment (admittedly losses from employment activities are extremely rare but not impossible).

The scope of the Australian deducting hybrid mismatch rules as originally enacted was expanded well beyond what was contemplated by the OECD Recommendations, as they covered a deduction/loss merely for it being deductible in both the source and resident countries by the same taxpayer. As most Australian resident MNEs operate through company structures, only their passive income should be affected by these rules. Their business deductions/losses were less likely to be affected by the deducting hybrid mismatch rules, since they are either not deductible (as related income is exempted under s 23AH of the *ITAA 36*), or are only deductible in Australia (because related income is shielded by Article 7 of relevant tax conventions). Consequently, the tax loss quarantining rules in the form of the deducting hybrid mismatch rules were likely to inflict more damage on SMEs, as they are more inclined to adopt trust or sole trader structures to carry out their cross-border transactions.

The policy reason underpinning this expansion of the rules from the OECD Recommendations was not publicised when the original deducting hybrid mismatch rules were introduced in 2018. It now appears the said expansion was unintended. The *Amending Act* was introduced to change, inter alia, the definition of "deducting hybrid" in s 832-550 from "a liable entity in at least one deducting country" to circumstances where the entity:

(1) is a liable entity in one deducting country (but not in both deducting countries); or
(2) satisfies the residency test in both deducting countries and is also a liable entity in both deducting countries.

This amended definition of deducting hybrid seems to limit the scope of the deducting hybrid mismatch rules to hybrid entities and/or dual resident entities. However, this definition does not cover a branch, because in normal circumstances the head office of a branch is the liable entity in both the deducting countries – that is, in its resident country and in the branch country – thereby being excluded from the definition by the proviso of the first limb of the definition as set out above.

The EM to the *Amending Act* does not provide an explanation as to why the Branch Recommendation was omitted. This seems to give rise to the opportunity to avoid tax through Separate Loss Utilisation – that is, a branch loss may be transferred to a subsidiary under a loss transfer mechanism (such as a fiscal unity regime) of a particular country.

This is not just a possibility – Australia itself has such a regime. Under Subdiv 170-A, a tax loss can be transferred from a branch of a foreign bank or a financial entity to a consolidated or multiple entry consolidated group or a subsidiary of the same wholly owned group in Australia, and vice versa. The branch is deemed as a separate legal entity for limited purposes[33] in order to notionally recognise some transactions between the branch and the foreign bank (ie the head office of the branch), such as notional borrowings by the Australian branch from the foreign bank, notional interest deemed paid on the notional borrowings and transfer pricing etc. This does not appear to make the branch a liable entity in Australia. Consequently, the foreign bank is a liable entity in both Australia and its own country, thereby falling outside of the amended definition of a deducting hybrid.

Other than this potential loophole, the amended definition seems to circumscribe the scope of the deducting hybrid mismatch rules to that suggested by the OECD Recommendations. Consequently, the amended deducting hybrid mismatch rules will not only liberate common and traditional cross-border business and investment transactions such as those in Example 3, but also turn loose substantial branch operations (such as bank branches) from their operation.

In summary, the scope of the deducting hybrid mismatch rules, as originally enacted, were considerably broader, while the scope of the amended rules is narrower than that suggested by the OECD Recommendations. In the authors' view, neither the OECD Recommendations nor the deducting hybrid mismatch rules, in their original form or as amended, achieve the Desirable Policy Outcome, as they focus on hybrid structures, which are only a means to achieve an end.

FURTHER PROPOSED AMENDMENTS

As discussed above, the mischief that the deducting hybrid mismatch rules should target is Separate Loss Utilisation – not the Offending Structures nor the loss transfer mechanism.

The appropriate legislative amendment option ("proposed Australian hybrid loss use rules") is arguably to directly tackle the root of the problem – namely, the Separate Loss Utilisation. This is effectively the idea behind the DCL rules contained in *Treasury Regulations* §§ 1.1503(d)-1–8 (*DCL Reg*), promulgated under s 1503(d) of the *IRS US*. Therefore, the proposed Australian hybrid loss rules rely heavily on the *DCL Reg* in the United States. (For convenience, hereinafter, all sections referenced are those of the *Treasury Regulations* .)

One of the most striking features of the DCL rules is their broad scope. Despite the fact that the DCL rules are contained in Chapter 6 – "Consolidated Returns of IRC US", this section may apply to a US domestic corporation, which has no association with any other corporation. For example, the DCL rules may apply to a US corporation that simply owns an interest in a foreign partnership that incurs losses. The fact that the real scope of the rules is much broader than expected will trap some taxpayers.[34]

In the authors' view, the proposed Australian hybrid loss use rules should operate in the following way:

(1) Prima facie, apply a blanket quarantine of the tax losses (ie the neutralising amount) (compare § 1.1503(d)-4).
(2) Then, create two important exclusions:
    (a) no foreign separate use (compare § 1.1503(d)-6(c)); and
    (b) Australian domestic use election (compare § 1.1503(d)-6(c)).

[33] *Income Tax Assessment Act 1936* (Cth) ss 160ZZW, 160ZZZK.

[34] J Kuntz and R Peroni, *U.S. International Taxation* (Warren Gorham & Lamont, 1991) [B1.05] (Disallowance of Dual Consolidated Loss (Section 1503(D)).

The idea is that, while the tax loss is blanket quarantined in the first place, it can be avoided by taxpayers:

- who adopt a simple structure (such as a stand-alone Offending Structure) without features enabling Separate Loss Utilisation under the first exclusion – "No foreign separate use" – this exclusion is to apply to the majority of traditional and common cross-border business and investment transactions; or
- who have an elaborate structure with features able to access Separate Loss Utilisation, by making an irrevocable Australian domestic use election to use the tax loss only in Australia (ie under this second exclusion, the tax loss can either be deductible in Australia or in a foreign country, but not in both).

Consequently, under the proposed Australian hybrid loss use rules, the definition of "deducting hybrid" in s 832-550 is no longer important and therefore need not be amended, as is done by the *Amending Act*. Entities undertaking common and traditional investment and business transactions (including those in Example 3 or those undertaken in stand-alone Offending Structures) may be a deducting hybrid, but they are excluded from the operation of the loss quarantining rules contained in Subdiv 832G under the "No foreign separate use" exclusion. Further, deducting hybrids with features conducive to accessing Separate Loss Utilisation, can nevertheless exclude themselves from the operation of Subdiv 832G by making an Australian domestic use election. The loss quarantining rules are then only activated where such an election is not made. Thus, the scope of Subdiv 832G is limited to being a backstop for tax loss in Australia, where the same tax loss is intended to be used in a foreign country.

The "neutralised amount" in the existing legislation can be adopted as the definition of the tax loss to be quarantined in the first place (to be consistent, the phrase "tax loss", instead of "neutralising amount", is used below). The tax loss so defined is roughly equivalent to the DCL as defined in § 1.1503(d)-1(b)(5). However, the definition of DCL is entity specific – that is, DCL is broadly defined as net (operating) loss of a dual resident corporation or a separate unit (which is a hybrid entity and business operation (ie a branch)[35]). The pitfall of this definition is that it does not accommodate the development of a new "species" of a potentially tax abusive (offending) structure. The recent addition (on 8 April 2020) of a "domestic consenting corporation" to the definition of a "dual resident corporation" in § 1.1503-1(c) is an example. The current definition of "neutralising amount" in Subdiv 832G does not suffer this pitfall, as it does not refer to specific abusive structures.

Section 1.1503(d)-4 is a central operating provision, which denies the US domestic use of a DCL under § 1.1503(d)-4(b), and quarantines DCL under a separate return limitation year (provisions §§ 1.1502-21(c), 1.1503(d)-4(c)). However, § 1.1503(d)-4 incorporates three exceptions (in § 1.1503(d)-6) (DCL exceptions), whereby the relevant US entity can utilise the DCL against either US income or foreign income, but not both – thereby achieving the Desirable Policy Outcome.

The two exclusions mentioned above and developed in this article are based on the DCL exceptions, provided in § 1.1503(d)-6(c) and (d),[36] elaborated further below.

No Foreign Separate Use

The inspiration behind this proposed exclusion comes from § 1.1503d-6(c). However, that section is not without its flaws. This DCL exception is rigid and inflexible – example 30 in § 1.1503(d)-7(c)(30) provides an example of no foreign separate use where an interest deductible in the United States was characterised as a principal payment in the foreign country, thereby being permanently denied as a deduction in that country – that is, the no foreign use is "absolute" in that example. This exception does not apply if there is a possible foreign use, even if this possibility is unlikely or remote. In example 2 of § 1.1503(d)-7(c)(2), this exception does not apply, because there is a possibility that a loss of a stand-alone

[35] All terms are defined in *Treasury Regulations* (US) §§ 1.1503d–1(b).

[36] Another exception is an inter-government agreement (*Treasury Regulations* (US) § 1.1503(d)-6(c)) under which losses in a particular year may be elected to offset income in one country. This is not discussed here. So far only the competent authorities of the United States and the United Kingdom have reached a mutual agreement, concerning how certain taxpayers may elect to use DCL either in the United States and United Kingdom – Announcement 2006-86, 2006-2 CB 842.

foreign branch of a US domestic corporation can be used by an affiliate, which may come into existence in the future. This example does not advise whether this foreign country has existing rules that enable the transfer of the loss from a branch to its affiliates.

In Australia, under this proposed "No foreign separate use" exclusion, an entity can self-assess, based on a well-developed "reasonable expectation"[37] that this exclusion applies if listed circumstances are unlikely to occur,[38] such as:

- Affiliation – a branch or a hybrid entity in a foreign country joins the consolidated group or other fiscal unit (eg an Australian investor incorporates a subsidiary, which forms a consolidated group with its branch in a particular country).
- Acquiring a reverse hybrid entity, which is fiscally transparent locally but opaque in Australia, such that the losses of a local branch or hybrid entity may be used to offset the business profit of this reverse hybrid entity, which is not assessable in Australia as it is viewed as a company in Australia.
- Transfer of an interest in a foreign hybrid – for example, where an Australian investor sells a 55% interest in a foreign hybrid entity, which is regarded as a local company and has carried forward losses. This can be regarded as one of the listed circumstances because the Australian investor may not be able to track the foreign losses as it has become a minority interest holder. The acquiring group (which can be another Australian group) should be entitled to the benefits of this foreign loss, since it did not use its portion of the loss earlier.
- Abandoning Australian residency by a dual resident entity in order to access the foreign losses in a future year, as it ceases to be an Australian taxpayer thereafter.
- Loss transfer event – such as making an election to transfer losses to an affiliate, or doing so through a merger, acquisition or other restructure, which enables the carrying over of losses to another entity.[39]

To safeguard Australian revenue, if a listed circumstance does occur within a specific period after the loss has been utilised in Australia, the taxpayer would be required to go back to amend the tax return denying the deduction, with interest imposed on the consequential additional tax (such as is imposed under s 102AAM of the *ITAA 36*). This is effectively the idea behind the recapture rules in the United States (§1.1503(d)-6(h)). The specific period (say eight years) should be long enough to ensure the net present value of the loss is considerably diminished. The Commissioner should be empowered to amend the original tax return for four years after the occurrence of the relevant circumstance.

The Australian Domestic Use Election

Where an entity has a structure with features (such as being a member of a consolidated group or owning a reverse hybrid entity etc) that enable it (whether intentionally or not) to access a tax loss in both Australia and a foreign country, it is proposed that the entity can make an Australian domestic use election to access the loss in Australia only, forgoing the foreign separate use of the same tax loss. Thus, under the Australian domestic use election, an entity can choose to use the loss either in Australia (by making the election) or in a foreign country (by not making the election), therefore ensuring only a single use of the loss, achieving the Desirable Policy Outcome – namely, that the economic profit is equal to the tax profit.

Again, to safeguard Australian revenue, similar rules of amending the original tax return to those under the "No foreign separate use" exclusion can be implemented – that is, if actual foreign separate use does occur within a specific period, the relevant entity is required to amend its tax return to deny the deduction, with interest payable on the additional tax.

The proposed Australian hybrid loss use rules should work well with the tax rules of other countries, whether they have an equivalent of the deducting hybrid mismatch rules or not, where:

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[37] *Commissioner of Taxation (Cth) v Peabody* (1994) 181 CLR 359, 385.

[38] The idea of these circumstances comes from *Treasury Regulations* (US) § 1.1503(d)-6 (Triggering event exceptions).

[39] See *Internal Revenue Code of 1986* (US) s 381.

(1) the counterpart country either does not have any deducting hybrid mismatch rules, or has deducting hybrid mismatch rules based on an election (such as in the United States), a taxpayer can deduct either the Australian loss or the foreign loss, but not both;
(2) the counterpart country has implemented the OECD Recommendations, then:
   (a) if that country is a primary response country, which in fact denies the loss, then the taxpayer can access the loss under the two exclusions;
   (b) if that country is a secondary response country:
      (i) if the taxpayers access the loss in Australia, the counterpart country's defensive rules should work to deny the loss in that country;
      (ii) if the loss is denied in Australia, as the two exclusions do not apply, then that counterpart country will allow the loss.

It is considered that the "No foreign separate use" exclusion should not be, in substance, subsumed into the "Australian domestic use election" exclusion, as occurs in the United States (ie the "No possibility of foreign separate use" exception can only be invoked in rare situations), allowing the two exclusions to be designed and developed based on different considerations.

The "Australian domestic use election" exclusion, for example, may not be suitable in situations where Separate Loss Utilisation is designed to occur in a low tax rate country, thus the Australian domestic use election will inevitably be made to offset more highly taxed income in Australia. In such a case a low rate kick out[40] rule can be added, disabling the "Australian domestic use election" if the applicable tax rate on the income that is likely to be offset by the tax loss is lower than the comparable Australian income tax rate by a designated percentage (say 40%). This low rate kick out rule need not be included in the "No separate foreign use" exclusion, which is intended to exclude simple structures devoid of features designed to facilitate tax avoidance.

Conclusion

This article put forward three important propositions:

(1) The root of the problem is Separate Loss Utilisation – not the Offending Structures. The right policy is to directly tackle Separate Loss Utilisation.
(2) A stand-alone Offending Structure is harmless and therefore should be excluded from the scope of rules developed to combat Separate Loss Utilisation.
(3) Even if an Offending Structure is deliberately put in place for the purpose of perpetuating tax avoidance through Separate Loss Utilisation, the better policy option is to limit use of the loss to one country, thereby achieving the outcome that the tax profit is in line with economic profit.

The proposed Australian hybrid loss use rules seem to achieve the following three policy outcomes, consistent with these important propositions. First, there is only single use of the loss, thereby eliminating the tax avoidance opportunity through Separate Loss Utilisation, while also achieving the Desirable Policy Outcome of taxing profit in line with the economic profit.

Second, most SMEs involved in common and traditional cross-border business and investment transactions are excluded from the convoluted deducting hybrid mismatch rules and can continue to enjoy the benefits of tax losses generated from cross-border transactions, as they did before the introduction of Subdiv 832G.

Third, MNEs with complex structures can nevertheless avoid the operation of Subdiv 832G and access tax losses in Australia, by electing to forgo the use of the same loss in a foreign country, which reduces the scope of Subdiv 832G to only quarantine tax losses in Australia where such an election is not made.

[40] This idea is derived from the high tax kick out rules contained in *Internal Revenue Code of 1986* (US) s 954(b)(4).