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Tax Group

Melbourne Law School

Tax and Transfer Policy Institute

Crawford School of Public Policy

Hosted by

Melbourne School of Government

Yan Zhuang

Research Assistant, Melbourne Law School

Daniel Minutillo

Research Fellow, Melbourne Law School
Teaching Fellow, Faculty of Business and Economics
The University of Melbourne

Miranda Stewart

Professor of Law and Director of the Tax Group,
The University of Melbourne
Honorary Professor, Tax & Transfer Policy Institute
Crawford School of Public Policy, ANU

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Tax Group
Melbourne Law School

The University of Melbourne
Parkville VIC 3010 Australia
www.unimelb.edu.au
CRICOS Provider No. 00116K

Tax and Transfer Policy Institute
Crawford School of Public Policy

The Australian National University
Acton ACT 2601 Australia
www.anu.edu.au
CRICOS Provider No. 00120C

Melbourne School of Government

The University of Melbourne
Parkville VIC 3010 Australia
www.unimelb.edu.au
CRICOS Provider No. 00120C

Summary

This policy brief makes the following key points:

- The G20/OECD Base Erosion and Profit Shifting (**BEPS**) Project is an international initiative intended to strengthen the international tax system through the adoption of a 15-point plan, and the 2021 Pillar One and Pillar Two consensus proposals.
- Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions. Hybrid mismatches are adopted in aggressive tax planning to achieve double non-taxation, or long-term taxation deferral, of transactions. Hybrid mismatches have a negative impact on tax revenues and may also have an overall negative impact on competition, efficiency, transparency and fairness.
- BEPS Action 2 targets hybrid mismatches resulting from differences in the tax treatment or characterisation by different jurisdictions of an instrument or entity. The BEPS Action 2 Final Report issued in 2015, combined with the 2017 report Neutralising the Effects of Branch Mismatch Arrangements (2017 Branch Mismatch Report), set out recommendations to address hybrid mismatches.
- The 2015 Action 2 report and 2017 Branch Mismatch Report recommend that governments amend their domestic tax laws to link the tax treatment of an entity or instrument to the tax treatment in another country, and thereby to address hybrid mismatch arrangements. The reports also recommend the development of model treaty provisions for hybrid mismatches. The recommendations are complex, as they address in detail a range of potential hybrid instruments or entities, and how governments should respond.
- Member states of the European Union (**EU**), Australia, New Zealand, the United Kingdom (**UK**) and the United States (**US**) have adopted the Action 2 recommendations or made changes to their laws to address hybrid mismatches. Australia has legislated these rules in Division 820 of the Income Tax Assessment Act 1997. The rules appear to have been successful in limiting or stopping hybrid tax planning.
- The anti-hybrid measures recommended for tax treaties are included in the Multilateral Instrument (**MLI**) established under BEPS Action 15 (see Policy Brief 13/2021).
- Despite this progress, most of the 140 countries in the Inclusive Framework on BEPS have not adopted Action 2 anti-hybrid policies, or have implemented different policies. The main reasons are concerns about negative economic effects; overlap with domestic rules; the complexity of the Action 2 rules; and a lack of administrative and technical capacity. It is not clear how many other countries will seek to introduce anti-hybrid rules in future. The OECD plans to share practical examples of hybrid rules amongst Inclusive Framework members to encourage adoption and ensure consistent, comprehensive and coherent outcomes from the application of new rules.

Introduction

The G20/OECD Base Erosion and Profit Shifting (**BEPS**) Project is an international initiative intended to strengthen the international tax system through the adoption of a 15-point plan, and the 2021 Pillar One and Pillar Two consensus proposals. This policy brief discusses BEPS Action 2 which targets hybrid mismatches resulting from differences in the tax treatment or characterisation by different jurisdictions of an instrument or entity. Hybrid mismatch arrangements are used by Multinational Enterprises (**MNEs**) to exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions.

This Policy Brief explains the concept of a hybrid mismatch and provides examples. It then discusses the 2015 Action 2 Final Report, which together with the 2017 report Neutralising the Effects of Branch Mismatch Arrangements (Branch Mismatch Report), sets out recommendations to address hybrid mismatches. It then explains how these recommendations have been implemented around the world and in Australia. While the European Union (**EU**), Australia, New Zealand, the United Kingdom (**UK**) and the United States (**US**) have generally adopted the Action 2 recommendations, the majority of countries that are members of the Inclusive Framework on BEPS have not done so. This Policy Brief discusses the possible factors that impact on the adoption of hybrid mismatch recommendations and policy trends for the future.

1 What is BEPS?

The G20 declared the era of bank secrecy over in 2009 and later called for action to strengthen international taxation standards. The OECD responded with a 15-point Action Plan to address taxation issues with digitalisation (Action 1); and reform the international tax system to bring cohesion (Actions 2-5), restore substance (Actions 6-10), improve transparency (Actions 11-14), and develop a multilateral instrument (Action 15). This launched the international project to prevent Base Erosion (or double non-taxation) and Profit Shifting from jurisdictions where profitable activities take place: the BEPS Project.

OECD working groups developed technical policy proposals (released October 2015), recommending updates to the model tax convention, OECD-issued guidance, and domestic policy. From November 2016, the Multilateral Instrument would update more than half of the world's bilateral tax agreements.

OECD/G20 BEPS project participation is now almost global with the launch of multiple global forums and the Inclusive Framework (now 139 jurisdictions), membership of which requires commitment to the BEPS four 'minimum standards'. Having broadly addressed its mandate to implement the proposed package, the Inclusive Framework delivered in October 2021 Pillar-One (on a new nexus approach) and Pillar-Two (on a minimum global tax) as consensus proposals to tackle the digitalising global economy.

2 Action 2: Neutralizing Hybrid Mismatches

What is the issue?

A hybrid mismatch arrangement exploits differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions. A hybrid mismatch entity or transaction may achieve double non-taxation, or long-term deferral of taxation and is one form of aggressive tax planning by MNEs. The typical outcome resulting from a hybrid mismatch arrangement is a deduction for a payment in one jurisdiction, and non-inclusion as income in another jurisdiction, or a double deduction in a transaction where more than one jurisdiction will permit a deduction for the same transaction, as characterised under its domestic law. It may be difficult to determine unequivocally which individual country has lost tax revenue under a hybrid mismatch, but an overall loss of tax revenue and erosion of the tax base of all countries involved arises.

The 2015 Action 2 Final Report (2015 BEPS Action 2 Report) set out recommendations regarding the design of domestic rules and the development of model treaty provisions to neutralise the tax effects of hybrid mismatch arrangements. The Action 2 Final Report targets hybrid mismatches resulting from differences in the treatment or characterisation of an instrument or entity in the tax laws of different jurisdictions. This work was subsequently expanded by the 2017 report on "Neutralising the Effects of Branch Mismatch Arrangements" (2017 Branch Mismatch Report) to deal with similar structures that arise through the use of branches.

The "hybrid" element of these arrangements may be a hybrid instrument, such as a financial arrangement that is treated as debt on which interest is deductible under the tax laws of one country but as equity under the tax laws of another country, on which dividends may be exempt. This may produce double non-taxation, because the deduction of an interest payment removes it from the tax base of one country, while the exemption for a dividend payment means it is not taxed in another country. Alternatively, it may be a hybrid entity, such as a legal entity that is treated as opaque (such as a company) for tax purposes in one country, but transparent (such as a partnership) in another. Hybrid instruments and entities can also be embedded in a wider arrangement or group structure to produce mismatch outcomes.

A hybrid mismatch arrangement may produce one of the following outcomes:

- **Deduction / non-inclusion**: a payment that is tax-deductible in one country, but is not considered taxable income in the country it is received;
- **Double deduction**: a payment that gives rise to two deductions in different jurisdictions, in respect of the same transaction;
- **Indirect Deduction / non-inclusion**: a payment that is deductible under the rules of the payer jurisdiction and that is set-off by the payee against a deduction under a hybrid mismatch arrangement.

Hybrid mismatches may also arise where a MNE conducts business through a branch in a jurisdiction. The 2017 Branch Mismatch Report identifies that the use of branch structures produces mismatches where the head office jurisdiction and the branch jurisdiction take a different view regarding the allocation of income and expenditure between the branch and head office. Branch mismatch arrangements include:

- Disregarded branch structures where the branch jurisdiction does not recognise the branch (deduction / non-inclusion);

- Diverted branch payments where the branch jurisdiction recognises the branch, but the payment to the branch is attributed to the head office by the branch jurisdiction, while the residence jurisdiction exempts the payment (deduction / non-inclusion);
- Deemed branch payments where the branch is treated as making a notional payment to the head office to offset the payment received, while the residence jurisdiction exempts this payment made to the branch (deduction / non-inclusion);
- Branch payments where the expenditure is deducted in both the residence and branch jurisdictions (double deduction); and
- Imported branch mismatches where the payee offsets the income from a deductible payment against a deduction arising under a branch mismatch arrangement (indirect deduction / non-inclusion).

Previous reports of the OECD indicated that hybrid mismatch arrangements have resulted in a substantial erosion of the tax base. These include the 2010 report Addressing Tax Risks Involving Bank Losses and the 2011 report Corporate Loss Utilisation through Aggressive Tax Planning. The available anecdotal evidence suggests that billions of dollars in tax revenues are at stake. For example, New Zealand has settled cases involving four banks for a combined sum exceeding NZD $2.2 billion, Italy has settled a dozen cases involving hybrids for an amount of approximately €1.5 billion. In the US, the amount of tax evaded in 11 foreign tax credit generator transactions was estimated at USD $3.5 billion.

What does the OECD Recommend?

The problem of hybrid mismatches is a product of the diversity of tax laws around the world. It could be fully addressed if countries around the world harmonised their income tax laws, but not surprisingly, this is not possible in practice. Another approach could be for countries to apply a general anti-avoidance rule (**GAAR**), but it is not straightforward to apply a GAAR to hybrid mismatches where the tax advantage arises from different tax treatment in different jurisdictions. Usually, a hybrid mismatch transaction complies with the domestic tax law of both countries. It is difficult to identify the "abuse" in such double non-taxation transactions, or even to determine which jurisdiction has lost tax revenue and should be entitled to tax the transaction. Some countries apply specific anti-avoidance rules (**SAAR**) to hybrid mismatch arrangements but these were not successful in all cases.

Following concerns raised by OECD member countries about aggressive tax planning with hybrid mismatches, evidenced in previous reports, the OECD undertook a review to identify examples of tax planning using hybrid mismatch arrangements. This led to OECD report, Hybrid Mismatch Arrangements: Tax Policy and Compliance issues (2012), which argued that hybrid mismatch arrangements have an overall negative impact on competition, efficiency, transparency and fairness in addition to tax revenues loss and presented various policy options to address hybrid mismatch arrangements.

The Hybrid Mismatch Report of 2012 concluded that a novel solution was needed: tax treatment of a hybrid entity or instrument in one jurisdiction should be **linked** to the tax treatment in another country. This approach, it was thought, had significant potential as a tool to address hybrid mismatch arrangements. The 2015 BEPS Action 2 Final Report draws on the Hybrid Mismatch Report of 2012.

The Action 2 report makes recommendations for the design of domestic rules and the development of model treaty provisions to neutralise the effects of hybrid instruments and entities. The Action 2 report comprises two different aspects. The first is specific recommendations for domestic law reform (Recommendation 2 and Recommendation 5) that aim to achieve a better alignment between domestic tax laws and their intended tax policy outcome. These recommendations aim to mend flaws in domestic tax laws that create opportunities for deduction / non-inclusion of income, or double deductions (Boer & Marres, 2015).

The second aspect is a proposal for governments to introduce hybrid mismatch rules in their domestic law, or in some aspects of treaties. These are linking rules that align the tax treatment of an instrument or entity in one jurisdiction with the tax treatment in another jurisdiction, without disturbing any of the other tax, commercial or regulatory consequences. These rules respond to a hybrid mismatch.

Recommendations for reforms to domestic law to prevent hybrid mismatches

For example, many countries provide an exemption for dividends paid to domestic residents that is designed to avoid double taxation across borders. However, if the dividend payments are deductible in the payer jurisdiction because of that country's tax laws, there is no double taxation and it is not necessary to exempt the dividend in the payee jurisdiction. If this anomaly can be fixed, specific anti-hybrid measures need not be applied. The recommended improvements include:

- Deny a dividend exemption where a dividend is deductible in the payer's jurisdiction (Recommendation 2.1);
- Limit duplication of foreign tax credits under a hybrid transfer to the extent of the taxpayer's net income under the arrangement (Recommendation 2.1);
- Improve Controlled Foreign Corporation (**CFC**) and other offshore investment tax regimes to catch payments to a reverse hybrid where the payment is deductible in the payer's jurisdiction (Recommendation 5.1);
- Restrict the tax transparency of a reverse hybrid that is a member of a corporate group, in respect of income that is not taxable for its investors (Recommendation 5.2); and
- Encourage information reporting requirements for tax-transparent entities established within the jurisdiction (Recommendation 5.3).

The intended result of these anti-hybrid rules is to prevent a mismatch, ensuring taxation in one jurisdiction, but there is a risk of double taxation if both countries apply the rules. To prevent double taxation, the hybrid mismatch rules are organised in a hierarchy.

Recommendations for specific rules to respond to hybrid mismatches

The Action 2 report also recommends introduction of specific hybrid mismatch rules to address Deduction /Non-Inclusion outcomes (Recommendations 1, 3 and 4); Double Deduction outcomes (Recommendations 6 and 7) and recommendations to address Indirect Deduction / Non-Inclusion outcomes (Recommendation 8).

For Deduction / Non-Inclusion outcomes, the primary rule is that the country of the payer will deny a deduction for the payment if the amount paid is not included in the taxable income of the payee in the counterparty jurisdiction. Where this primary rule is not applied, the counterparty jurisdiction will be able to apply a secondary, defensive, rule. The secondary rule would include the payment received in taxable income of the payee. For Double Deduction outcomes, the primary rule is that the investor jurisdiction denies the deduction and the defensive rule denies the payer's deduction.

Table 1 provides a general overview of these hybrid mismatch rules.

Table 1: General Overview of the Hybrid Mismatch Rules

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
Deduction/Non-Inclusion	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Control group and structured arrangements
Double Deduction	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to control group and structured arrangements
	Deductible payment made by a dual resident		Deny resident deduction	-	No limitation on response
Indirect Deduction / Non-Inclusion	Imported mismatch arrangements		Deny payer deduction	-	Members of control group and structured arrangements

Source: Table 1.1, Action 2 Final Report, page 20

Anti-hybrid treaty rules

The Action 2 Final Report recommends several anti-hybrid rules to be adopted in bilateral tax treaties. These rules deal with dual-resident entities, transparent entities and any consequential interactions between reforms to domestic tax law and the OECD Model Tax Convention.

The Action 2 Final Report proposes a new treaty provision addressing transparent entities to be included in Article 1(2) of the OECD Model Tax Convention (2017). It also notes the 2015 BEPS Action 6 Report on addressing treaty abuse addresses some BEPS concerns related to dual-resident entities (see Policy Brief 6/2021). The Action 6 report seeks to address cases of dual residence under a tax treaty on a case-by-case basis rather than on the basis of the place of effective management of entities. More generally, the Action 2 Final Report recommends that countries may move to the credit method to alleviate double taxation, where the exemption method continues to raise concerns about double non-taxation under tax treaties.

The 2015 BEPS Action 2 anti-hybrid recommendations for tax treaties are included in part II of the MLI, to assist speedy uptake of these treaty amendments. This includes Article 3 (Transparent Entities), Article 4 (Dual Resident Entities) and Article 5 (Application of Methods for Elimination of Double Taxation).

The 2017 Branch Mismatch Report applies a similar analysis and solutions to neutralise branch mismatches, to prevent taxpayers shifting from hybrid mismatch to branch mismatch arrangements to minimise tax. Recommendation 1 is comparable to the specific recommendations in the 2015 BEPS Action 2 report. It narrows the scope of the branch exemption to reduce the frequency of branch mismatches. Recommendations 2 to 5 are similar to the hybrid mismatch rules, which require adjustments in respect of branch mismatches.

3 How has the Action Been Implemented Globally?

Since the 2015 BEPS Action 2 Report and the 2017 Branch Mismatch Report, a number of countries that are members of the Inclusive Framework have adopted rules to address a comprehensive range of hybrid and branch mismatches. However, countries have adopted different approaches to designing relevant amendments to domestic laws, so these differ from country to country and rule to rule.

Based on the IBFD BEPS Country Monitor, progress in the adoption of recommendations of the Action 2 report in 88 Inclusive Framework member countries has been uneven. To date, 44 jurisdictions have adopted at least one hybrid mismatch recommendation in domestic law. Action 2 enthusiasts include Australia, the EU and its member states, New Zealand, the UK and the US. In 2016, the UK enacted legislation consistent with the main approach of Action 2, followed by New Zealand in 2018. In 2019, the US Treasury issued regulations clarifying the application of the hybrid mismatch rules introduced under the *Tax Cuts and Jobs Act 2017 (US)*.

The EU Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164 (**ATAD**) was adopted in 2016 and amended by Council Directive (EU) 2017/952 (**ATAD II**) in 2017 to respond to BEPS Action 2. This Directive required hybrid and branch mismatch rules to be effective in member states by the start of 2020. All 27 EU member states have enacted most of the amendments to the EU Parent-Subsidiary Directive (Council Directive 2014/86/EU) and the **ATAD** (amended by **ATAD II**) into domestic laws. The amendments to the provisions on reverse hybrids were enacted from 1 January 2022. The approach adopted by the EU to address hybrids and align the legal characterisation of debt/equity rules and opaque/transparent entities goes beyond the recommendations of the Action 2 Report. Essentially, the primary rule for addressing mismatches is mandated. In the event of a hybrid mismatch, the legal characterisation given to a hybrid instrument or entity by the EU member state where a payment originates must be followed in the payee member state jurisdiction.

Canada announced a proposal for new hybrid mismatch rules consistent with OECD recommendations in its 2021 federal budget, to be implemented in two legislative packages. The first package would comprise rules in line with the recommendations to neutralize a Deduction / Non-Inclusion outcome arising from a financial instrument and would apply as of July 1, 2022. The second package would address other hybrid mismatch arrangements and apply no earlier than 2023.

Regarding treaty anti-hybrid amendments, according to the MLI database, by November 2021, 21 out of 95 signatory jurisdictions have accepted Article 3 without reservations while 65 had lodged or foreshadowed a general reservation against Article 3. Articles 4 and 5 are more widely accepted, but 58 jurisdictions reserve the right not to apply all of Article 4, and 41 jurisdictions do the same regarding Article 5.

Table 2 summarises how countries have responded to the BEPS Action 2 recommendations. Most government responses have aimed to neutralize mismatches from hybrid instruments (Recommendation 1) and to deny a dividend exemption where the dividend is deductible to the payer (Recommendation 2.1).

Table 2: Global implementation of hybrid mismatch recommendations in domestic laws (31/10/2021)

Recommendations		Number of Countries
Recommendation 1	Special rules to prevent a taxpayer from achieving a deduction/non-inclusion (D/NI) outcome	41
Recommendation 2	Denial of tax relief (e.g. exemption) for payments that are treated as deductible by the payer	41
Recommendation 2	Limitation on the ability to claim relief for foreign withholding tax on instruments that are held subject to a hybrid transfer	28
Recommendation 3	Disregarded hybrid payments rules	33
Recommendation 4	Reverse hybrid rules	25
Recommendation 5	Offshore investment regime rules to prevent D/NI outcomes in respect of reverse hybrid payments	5
Recommendation 5	Offshore investment regime rules to prevent D/NI outcomes in relation to imported mismatch arrangements	4
Recommendation 5	Restricts the tax transparency of reverse hybrids that are members of a control group	15
Recommendation 5	Special tax filing and information reporting obligations in respect of tax transparent entities established within its jurisdiction	2
Recommendation 6	Deductible hybrid payments rules to prevent a double deduction (DD) outcome (i.e. the payment is deductible in more than one jurisdiction)	35
Recommendation 7	Dual resident payer rules to prevent a DD outcome	34
Recommendation 8	Denial of deduction for any imported mismatch payment to the extent that the payment gives rise to an indirect D/NI outcome	31
Recommendation 9	Follows the design principles included in Recommendation 9 of BEPS Action 2	18
Recommendation 9	Monitors and reviews the measures taken for the fulfilment of Action 2	10
Recommendation 9	Co-ordinates with other jurisdictions the fulfilment of Action 2	10
Recommendation 10	Definition of structured arrangement	29
Recommendation 11	General definition of related persons and control group	37
Recommendation 12	Introduced general definitions for terms included in Recommendation 12	23

Source: IBFD, BEPS Country Monitor (31/10/2021)
Notes: 1. 5 out of 29 countries implement policies not fully in line with Action 2 recommendation 10.
2. 20 out of 37 countries implement policies not fully in line with Action 2 recommendation 11.
3. 12 out of 23 countries partially adopt general definitions recommended in recommendation 12 or include them under other domestic law.

4 How has Australia Implemented the Action?

Government response

Australia was an early mover in the implementation of anti-hybrid rules, taking steps several months before release of the Action 2 Final Report. As part of the 2015 Budget, on 12 May 2015, the Australian Government asked the Board of Taxation to consult on proposed new anti-hybrid laws pursuant to the Action 2 recommendations. The Board of Taxation recommended that the Australian Government adopt each of the Action 2 recommendations with minor modifications.

In its 2016 budget, the Government announced that it would implement the OECD anti- hybrid rules. In the 2017 budget, it was announced that the hybrid mismatch rules would also apply to regulatory capital of banks and financial institutions. The government estimated that the hybrid mismatch rules would have an 'unquantifiable gain to revenue'.

Although Australia's anti-hybrid rules largely followed the OECD recommendations, the targeted hybrid mismatch integrity rule announced in November 2017 goes further than the Action 2 recommendations. The Australian Government considered that this rule would apply to 'financing arrangements through interposed entities in zero tax countries which reduce Australian profits without those profits being subject to foreign tax'. In simple terms, this new unilateral measure is designed to override the hybrid mismatch rules and impose additional Australian tax on interest and derivative payments to foreign interposed zero or low-rate lenders, irrespective of whether the arrangement is a hybrid.

Australia introduced its hybrid mismatch rules in the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018 (2018 Act). The rules are mainly in Division 832 of the Income Tax Assessment Act 1997 (**ITAA 1997**) and have effect for income years beginning on or after 1 January 2019. To clarify operational issues and strengthen the hybrid mismatch integrity rule, Division 832 of the ITAA 1997 was amended by Treasury Laws Amendment (2020 Measures No. 2) Act 2020.

Table 3: Australian Hybrid Mismatch rules in Division 832 of ITAA 1997

Division 832	Hybrid Mismatch outcome	Hybrid mismatch	Corresponding OECD Recommendations
Subdivision 832-C	Deduction/Non-inclusion	Hybrid Financial Instrument mismatch	Recommendation 1 of the 2015 BEPS Action 2 Report
Subdivision 832-D		Hybrid payer mismatch	Recommendation 3 of the 2015 BEPS Action 2 Report
Subdivision 832-E		Reverse hybrid mismatch	Recommendation 4 of the 2015 BEPS Action 2 Report
Subdivision 832-F		Branch hybrid mismatch	Recommendation 2 of the 2017 Branch Mismatch Report
Subdivision 832-G	Double Deduction	Deducting hybrid mismatch (including foreign subsidiary and foreign branch)	Recommendation 6 of the 2015 BEPS Action 2 Report; and Recommendation 4 of the 2017 Branch Mismatch Report
Subdivision 832-H	Imported hybrid mismatch	Indirectly fund a hybrid mismatch	Recommendation 8 of the 2015 BEPS Action 2 Report; and Recommendation 5 of the 2017 Branch Mismatch Report
Subdivision 832-J (Targeted Integrity Rule)		Deductible in Australia where an outgoing payment among foreign-controlled groups is subject to foreign tax at 10% or less.	N/A

Table 4: Amendments to other Legislation

Legislation	Hybrid mismatch amendment	Concept	Corresponding OECD Recommendation
Subdivision 768-A	Non-porfolio dividend exemption amendments	Deny exemption for foreign equity distribution in connection with the hybrid mismatch	Recommendation 2.1 of the 2015 BEPS Action 2 Report
Section 23AH of the Income Tax Assessment Act 1936 (ITAA 1936)	Active foreign branch profits exemption amendments	Deny exemption for foreign branch income in connection with a branch hybrid mismatch	Recommendation 2 of the 2017 Branch Mismatch Report
Section 207-158	Deductible/frankable distributions amendments	Deny imputation benefits for shareholders on distributions where a foreign income tax deduction incurred	Recommendation 2.2 of the 2015 BEPS Action 2 Report
Part IIIB of the ITAA 1936	Double deduction by foreign bank branches amendments	Deny deductions for notional payments	Recommendation 3 of the 2017 Branch Mismatch Report

Note: All references in this table are to the ITAA 1997 unless otherwise stated.

Tax treaty amendments

Australia signed and ratified the MLI and it was given the force of law by the Treasury Laws Amendment (OECD Multilateral Instrument) Act 2018 and it entered into force for Australia on 1 January 2019, and notified to the OECD under section 4A on 10 January 2019. The main features of Australia's adoption of the anti-hybrid rules in part II of MLI are as follows:

- Under Article 3, treaty benefits will be granted for income derived by or through a transparent entity only to the extent that the income is treated as the income of a resident of one Contracting Jurisdiction. Australia has adopted Article 3 but preserves bilateral rules where appropriate, such as in the Australia-France tax treaty and the Australia-Japan tax treaty.

- Article 4 expands the tiebreaker test for dual-resident entities to include other factors besides the place of effective management and the place where it is incorporated. The competent authorities of the Contracting Jurisdictions shall endeavour to determine its single country of residence by mutual agreement. Australia has adopted Article 4 but not the rule that would allow two tax administrations to grant treaty benefits in the absence of mutual agreement.

- Article 5 ensure that countries relieve double taxation by providing a credit for foreign tax rather than an exemption for foreign income. Australia has not adopted Article 5. All of its treaties apply the credit method in relieving double taxation for Australian residents, although Australia does provide an exemption for foreign dividends in certain circumstances and this has not been repealed.

Administrative response

The anti-hybrid rules in Division 832 of ITAA 1997 are complex. The Australian Taxation Office (**ATO**) has released detailed guidance to explain hybrid mismatch concepts and assist in applying the rules:

- Law Companion Ruling 2019/3 OECD hybrid mismatch rules – concept of structured arrangement.
- Law Companion Ruling 2021/1 OECD hybrid mismatch rules - targeted integrity rule.

- Practical Compliance Guideline 2018/7 on Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements. This sets out the approach to application of Australia's GAAR (Part IVA of the Income Tax Assessment Act 1936) and how it interacts with the hybrid mismatch rules.
- Practical Compliance Guideline 2019/6 OECD aims to assist taxpayers in self-assessing their risk under the hybrid mismatch rules – particularly in relation to 'structured arrangements'.
- Practical Compliance Guideline 2021/5 Imported hybrid mismatch rule - sets out the ATO's assessment of the relative levels of tax compliance risk associated with imported hybrid mismatches, including the ATO's approach to review whether a taxpayer has undertaken reasonable enquiries in relation to the rules for non-structured arrangements.
- Draft Tax Determination 2019/D12 regarding section 951A of the US Internal Revenue Code. This draft determination addresses the US global intangible low taxed income (**GILTI**) rule and concludes that the rule does not give rise to an amount regarded as subject to foreign income tax for the purposes of the hybrid mismatch rules.

To assist taxpayers in interpreting and applying the hybrid mismatch rules, the ATO is expected to release more guidance in the future. For example, the Compendium of PCG 2021/5EC indicated that the ATO will provide guidance on the principles for identifying whether a country has corresponding hybrid mismatch rules.

The Board of Taxation recommends that a post-implementation review of Australia's hybrid mismatch legislation be undertaken, preferably after a number of other jurisdictions have implemented hybrid mismatch rules and in light of any further recommendations made or best practice approaches suggested by OECD Working Party 11 in relation to the Action 2 Report.

5 Impact

The hybrid mismatch rules are a novel solution to the problem of international tax arbitrage and double non-taxation. The extension of country tax rules to take into account the tax treatment in another jurisdiction is a further step in the interdependence of country tax systems, while still acknowledging diversity of national tax laws. Most country hybrid mismatch rules have only been operational for a couple of years, so there is limited evidence of their effectiveness. The rules may work best by stopping the use of hybrids in aggressive tax planning, rather than unwinding all of the consequences of hybrid transactions. Ultimately, the goal of the hybrid mismatch rules is to increase effective taxation of financial and entity hybrids across borders. If effective, this will likely increase the after-tax cost of cross-border financing arrangements.

The hybrid mismatch rules are precise, but complex. The 2015 BEPS Action 2 report anticipated that taxpayers would face compliance costs associated with the hybrid mismatch rules. This is because they would "restructure existing arrangements to avoid any adverse tax consequences associated with hybridity" (p. 101) in response to the Action 2 recommendations. This would give rise to short-term cost to taxpayers, from the unwinding or restructuring of existing arrangements, such as break fees, advisor fees and foreign exchange differences). A common challenge for taxpayers, and administrators in applying the hybrid mismatch rules is the requirement to make judgements about the operation of foreign tax laws. The presumption that the taxpayer has perfect knowledge of its global MNE group structure, relevant foreign laws and the flow of payments through the group structure may not always be borne out in practice.

6 What comes next?

Some governments have been cautious about whether to adopt hybrid mismatch rules, especially capital importing countries, because of a potential negative impact on the investment climate (de Boer & Marres, 2015). If taxpayers have plenty of options to restructure to still obtain the same or similar tax benefits, those jurisdictions which are among the first to introduce anti-hybrid measures may lose attraction for MNEs. Another issues that may impede worldwide adoption of the BEPS Action 2 recommendations is that the recommendations overlap with a jurisdiction's existing tax rules, such as a general anti-avoidance rule, transfer pricing rules or pre-existing anti-hybrid rules. Over time, this issue may become less important.

Of greater importance, as explained in the 2021 report Developing Countries and the OECD/G20 Inclusive Framework on BEPS, is a lack of legislative, technical and administrative capacity in most developing countries, which have been slow to adopt the recommendations of Action 2. The design and drafting of anti-hybrid rules should take account of their practical implementation by administrators and taxpayers as noted by Brabazon (2019), and hybrid mismatch rules need to be capable of being understood and made to work. Yet even if these rules were legislated in many developing countries, they may not be able to be effectively administered.

Despite this, it seems likely that hybrid mismatch rules are here to stay among the developed countries that have adopted them and they may gradually spread elsewhere in the world. The OECD in its Explanatory Statement on the 2015 Reports indicated that, in respect to hybrid mismatch arrangements, countries have agreed on a general tax policy direction but not on the details of its implementation. The OECD expects that countries will converge over time in the implementation of agreed common approaches. This would enable further consideration of whether such measures should become minimum standards in future. The OECD also aims to support the members of the Inclusive Framework to share practical examples of these structures to ensure consistent, comprehensive and coherent outcomes from the application of anti-hybrid rules.

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