# Australia

# Targeted Integrity Rule and Its Application

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**Although Australia introduced the targeted integrity rule to forestall multinationals circumventing the hybrid mismatch rules introduced in 2018, the law including the rule has several areas of interpretation that are new and therefore may result in confusion and conflict.**

## 1. Introduction

The measures to combat the use of hybrid mismatch in Australia were first enacted in the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018. This law also included a targeted integrity rule (TIR). The rule became effective from 1 January 2019. It was further amended by Treasury Laws Amendment (2020 Measures No. 2) Act 2020.

The explanatory memorandum to the 2020 Act states as follows:

> A targeted integrity rule will prevent the effect of the hybrid mismatch rules to neutralize double non-taxation outcomes from being compromised by multinational groups using interposed conduit type vehicles to invest into Australia (as an alternative to investing into Australia using hybrid instruments or entities or investing into Australia directly).[1]

Without the integrity rule, these structures can be used to effectively retain a deduction/non-inclusion outcome. The Rule as enacted contains several issues that may result in conflicting views and disputes. In order to alleviate this, the Australian tax office has released a Ruling, Law Companion Ruling, LCR 2021/1. This article will discuss in detail the explanations given by the Tax Office in the Ruling.

## 2. Anti-Hybrid and Targeted Integrity Rules

The anti-hybrid rules were enacted to prevent parties gaining tax advantage from tax mismatches that arise due to dissimilar tax treatment of entities and financial instruments in different jurisdictions. The rules were modeled on the recommendations by the OECD in its “Neutralizing the effects of hybrid mismatch arrangements, Action 2 -2015 Final Report, 2015”. However, the Australian government went even further in its effort to curtail entities misusing the hybrid rules by the enactment of the targeted integrity rule.

Broadly, the anti-hybrid rules apply in the following situations:

- a deduction/deduction mismatch, where the business receives deductions in two jurisdictions in respect of the payment (D/D);
- a deduction/non-inclusion mismatch, where the business receives a deduction in respect of the payment in one jurisdiction, but does not include the payment as income in another jurisdiction (D/NI).

Despite the introduction of the anti-hybrid rules it was noticed that multinational businesses could, while staying within the hybrid rules, still engage in activities that went against the spirit of the recommendations of the OECD. This may well be achieved by multinationals investing into Australia through interposed entities located in no- or low-tax jurisdictions, so that even if the anti-hybrid rules apply, the eventual tax liability would still be lower than where the investment in Australia was direct and not through an interposed entity in the low-tax jurisdiction. This is accomplished by replicating the D/NI situation mentioned above, in which deduction for a payment will be obtained in Australia but the income from the payment, although included in the income in the low-tax jurisdiction, is not taxable or taxed at a reduced rate.

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1. AU: para. 1.7 Explanatory Memorandum 2020 Act, available at https://www.legislation.gov.au/Details/C2020B00067/Explanatory%20Memorandum/Text (accessed 21 June 2021).

The TIR will apply if the following circumstances exist:

- an entity (the paying entity) makes a payment to a foreign entity (the interposed foreign entity), either directly or indirectly;
- the paying entity, the interposed foreign entity and another foreign entity (the ultimate parent entity) are all in the same Division 832 control group;[2]
- the ultimate parent entity is not controlled by any other entity (other than an entity that is not a member of the Division 832 control group);
- disregarding section 832-725, an entity would otherwise be entitled to a deduction in an income year in respect of the payment;
- the payment is not subject to Australian income tax;
- the payment is either:
  - subject to foreign income tax in one or more foreign countries with the highest rate of tax not exceeding 10%; or
  - not subject to foreign income tax; and

  it is reasonable to conclude (having regard to the matters referred to below) that the entity, or one of the entities that entered into or carried out any part of the scheme, did so for a principal purpose of enabling:

  - a deduction to be obtained in respect of the payment; and
  - foreign income tax payable on the payment be less than 10%.

The matters referred to above in respect of the principal purpose are:

- the facts and circumstances that exist in relation to the scheme;
- if the payment is an amount of interest, the source of funds used by the interposed foreign entity to provide the paying entity with the loan or other debt interest on which the interest payment is made; and
- whether the interposed foreign entity engages in substantial commercial activities carried on a banking, financial or similar business.

It is not clear whether when determining the existence of the requisite principal purpose to reduce or avoid tax, any other matter other than referred to above could be taken into consideration. In response to a query raised about this in LCR 2021/1, where the loan is funded by way equity from retained earnings of an active financing business the Commissioner states that a ruling cannot address all possible circumstances. It appears that the Commissioner would take a broad approach when detecting the requisite principal purpose and that multinationals take a long hard look at their investment strategies if they wish to avoid any adverse determinations by the Commissioner applying the TIR. In this connection it is to be noted that in determining whether there had been a dominant purpose to avoid tax under anti-avoidance provisions contained in Part IVA of ITAA 1936, section 177D(2) of the Act lists several matters to be taken into consideration, giving the Commissioner a wide range of circumstances in finding that there had been the requisite principal purpose for the application of the TIR.

If TIR applies, deduction for the whole of the payment will be denied in Australia, which will result in the taxpayer group not gaining any tax advantage by devising the conduit scheme involving a foreign imposed entity through which the investment in Australia was made.

## 2.1. Division 832 control group

One of the pivotal requirements for the TIR to apply is that the paying entity, the interposed foreign entity and the ultimate parent entity are in the same Division 832 control group. Two or more entities will be taken to be in the same control group if:

- the entities are consolidated with another for accounting purposes in the same group;[3]

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2. Sec. 832-205 ITAA 97.
3. Australian Accounting Standard AASB 10 (Consolidated Financial Statements):

   1. The objective of this standard is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.
   2. To meet the objective in paragraph 1, this Standard

- one of the entities holds a total participation interest of 50% or more in the other entity (or each of the other entities); or
- the third entity holds a total participation interest of 50% or more in each of the (subsidiary) entities.

The above three requirements need not be present at the same time and therefore a control group could exist even if one of the entities does not have at least 50% participation interests in other entities. This could occur if the entities are consolidated for accounting purposes, where actual control would be sufficient to consolidate, even when the participation interest is less than 50%.

The TIR does not require that the Division 832 control group members be consolidated under tax laws, which is applicable only if the members are wholly owned by the parent entity. Moreover, consolidation is not compulsory under tax law and entities are allowed not to make the election to tax consolidate, especially because of the "one-in-all-in" principle under which all entities wholly owned by the head company automatically fall into the tax group once the election is made to tax consolidate. Since the rule does not require that there be a tax consolidation, it can be said that the rule has a wider net of entities to which it can apply. This is evident from the TIR requirement, that even a participation interest of at least 50% or more would be sufficient to make the rule apply.

In the final analysis, in addition to the accounting consolidation requirement, the rule will apply even if the parent entity has a participation interest of at least 50% in the subsidiary. Control is the determining factor in accounting consolidation and it can only be established if the parent has power over the subsidiary or exposure or rights to variable returns from its involvement with the subsidiary and the ability to use its power over the subsidiary to affect the amount of the returns from the subsidiary. It is clear that it will be difficult to establish power over the subsidiary, but not so in the case of at least 50% participation interest. Here again, the rule will apply in more cases than since accounting consolidation is the criterion.

## 3. Extent of Deduction Denied

It was raised during the consultation period leading up to the issue of the Law Companion Ruling (LCR) whether it is relevant to consider the extent of the denial of deduction in cases where the headline rate of taxation in the country of the ultimate parent entity (UPE) is greater than 10%, but due to deductions that would be allowed in the country of the UPE, the effective tax rate falls below 10%. In the LCR, the Commissioner states that the tax rate to be taken into consideration is not the effective tax rate (after the deduction for expenses) but the rate that was applicable to the whole of the payment.[4]

Where the foreign country in which the UPE is taxable provides a deduction or any other concession for the tax that would apply to the entity's profit, they are relevant in determining the rate of tax applied to the whole of the payment.

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(a) Requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements;

(b) Defines the principle of control, and establishes control as the basis for consolidation;

(c) Sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee;

(d) Sets out the accounting requirements for the preparation of consolidated financial statements; and

(e) Defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.

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5. An investor, regardless of the nature of its involvement with an entity (the investee) shall determine whether it is a parent by assessing whether it controls the investee.
6. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
7. An investor controls an investee if and only if the investor has the following:

(a) power over the investee;

(b) exposure or rights to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

8. An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee's returns.

4. Para. 51 LCR.

**Example 1**

Suppose the country in which the UPE is taxable imposes tax at the rate of 11%, which is deductible when determining the tax liability. UPE receives an interest income of AUD 300 and therefore would be liable to 300 × 11% = AUD 33 tax. However, the net profit (because deduction of tax allowed) = AUD 300 – AUD 33 = AUD 287 and the tax actually payable is AUD 287 × 11% = AUD 29.37. Therefore the effective tax rate is 29.37/300 × 100 = 9.79% (effective rate of tax is based on the actual tax paid on the total amount of interest paid). Since the rate is below 10%, the rule will apply to the interest payment and deduction will be denied in Australia.

## 4. Tax Transparency of the UPE

If the UPE is tax transparent, its investors would be liable to tax depending on their status (whether individuals, companies, trusts or partnerships) and accordingly the rate of tax will vary depending on the entity that is actually taxed, resulting in difficulty in determining whether the whole of the payment is taxed at the prescribed tax rate of 10% or more.

The payment by the interposed foreign entity is made to the UPE and it is that payment that is examined to determine the tax rate applicable to it in the foreign country and not the tax rate applicable to each of the investors in the UPE. Therefore, if the payment is passed through to the investors, it will be the overall effective tax rate that will be taken as the tax rate to be matched against the 10% threshold. The relevant requirement for the application of the rule is that the payment (i.e. not the entity) is either:

- subject to foreign income tax in one or more foreign countries with the highest rate of tax not exceeding 10%; or
- not subject to foreign income tax.

However, the Commissioner acknowledges that the circumstances of the recipient of the payment or the UPE could be a relevant consideration in ascertaining whether the requisite purpose exists for triggering the rule.

## 5. Principal Purpose Test

According to section 832-725(1)(h) of ITAA 97, the rule will apply only if it is reasonable to conclude that the entity or one of the entities who entered into or carried out any part of the scheme, did so for a principal purpose of, or for more than one principal purpose that includes a purpose of enabling:

- a deduction to be obtained in respect of the payments; and
- foreign income tax to be imposed on the payment at the rate of 10% or less, or enabling foreign income tax not to be imposed on the payment.

This test is similar to the test found in the general anti-avoidance provisions contained in the ITAA 97 and the Commissioner has expressed the view that interpretation of this provision will be similar to that used in the former case.

However, for the purpose of determining whether it is reasonable to conclude that the principal purpose referred to above was present, matters included in section 832-725(2) must be given due consideration.

The Ruling goes extensively into the above-referred matters:

(1) The facts and circumstances that exist in relation to the scheme. When deciding whether there is a principal purpose in entering into the scheme, the facts and circumstances surrounding the event must be considered. As an example, the Commissioner refers to the fact of the indirect funding of the interposed entity. In Example 1 above, interest payment is made to the interposed limited partnership, the majority in it is held by investors outside the Division 832 Control Group. This fact would dilute the benefit of the scheme enjoyed by members of the control group and therefore may have taken into consideration whether the requisite principal purpose by the members of the control group is satisfied. LCR 2021/1 states that in practice, these facts would need to be weighed up against other facts and circumstances of the scheme, including the matters specified in paragraphs 832-725(2)(b) and (c) in determining whether paragraph 832-725(1)(h) is met.

(2) The source of the funds used by the interposed foreign entity (the payee) to provide the entity (the payer) with the loan or other debt interest (in respect of which the interest payment is made). In this context, the source of the funds used by the interposed entity to provide the loan to the Australian company will be relevant. The test would be satisfied if the UPE routes

its investment into Australia through an interposed entity converting taxable interest income into exempt dividend, return on investment (from the interposed entity).

(3) Whether the interposed foreign entity (the payee) engages in substantial commercial activities in carrying on a banking, financial or other similar business.

If from the facts and circumstances it could be established that the interposed entity is carrying on substantial commercial activities on its own, the rule may not be applicable. Since the interposed entity is taken to have provided funds to the Australian company for which interest is being paid (and deductions claimed in Australia), the rule will apply unless the funds were provided in the course of the interposed entity that carried on a business in banking, financial and other similar activities. In the ruling the Commissioner points out a list of factors that may be taken into consideration when determining whether there had been a financial business by the interposed entity:

- the undertaking of spread activities common to banking business;
- actual borrowing and lending activities, and the identity of the lenders and borrowers;
- a pooling of funds approach (typically a feature in the banking and finance industry) that would make it difficult to ascertain the source of funds;
- risk management activities consistent with such a business; and
- whether the interposed entity is capitalized in a manner and at a level consistent with that of a stand-alone entity engaged in such business.

The Commissioner reiterates that the factors listed above are only indicative of a financial services business and cannot be considered as exhaustive.

As would be in a typical hybrid arrangement, the funding by the interposing entity would be provided by equity injection from the UPE. In that case the rule will be applicable.

# 6. Controlled Foreign Company Exception

The rule will not apply and the payment by the Australian company will not denied deduction, if:

- the payment is included in the income of the interposed foreign entity, under the CFC rules and the attribution percentage of each attributable taxpayers is at least 100%;
- similar controlled foreign company rules apply to the interposed foreign company; or
- CFC rule in Australia are contained in Part X of the ITAA 1997. Basically, if the CFC does not pass the active income test, the CFC rules will tax:
    - the adjusted tainted income of a CFC if it is resident in an unlisted country;
    - the eligible designated concession income if the CFC is resident in a listed country.

The persons who will be liable to tax are the attributable taxpayers who are resident in Australia. The listed countries are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. All other countries are unlisted countries.

**Example 2**

AusCo, an interposed foreign company and a UPE are members of a Division 832 control group. AusCo makes an interest payment to the interposed foreign company. The interposed foreign company is subject to income tax at the rate of 15% but is allowed a deduction for the withholding tax paid in Australia amounting to 10% of the interest payment.

Since the interest payment is subject to foreign tax of more than 10%, the interest payment made by AusCo will not be subject to the rule.

Suppose the UPE's equity contribution in the interposed foreign company was the source of its funds given out as loan to AusCo. Since the UPE made an equity contribution to the interposed company, it will be entitled to the participation exemption and hence the dividend received by the UPE will be exempt.

The source of the funding strongly points to the requisite purpose existing for the TIR to apply.

## 7. Back-to-Back Arrangements

The rule applies to back-to-back arrangements, where interest payments are made. This is so regardless of the rate of tax applied to the interest payment. If the rule applies the payment will be considered as made by the Australian entity directly to the UPE. The explanatory memorandum states that a back-to-back loan (or an arrangement that is economically equivalent and intended to have a similar effect) would exist where the recipient of the payment has an effective obligation to pass on substantially the entire amount to a third party under another loan or similar arrangement.

The explanatory memorandum noted that in most back-to-back arrangements falling within the rule, the loan from the UPE to the interposed entity and the loan from the interposed entity to the Australian entity would be sufficiently the same. However, it also observed that differences in denominated currencies of the two loans and the amount of the loans would not necessarily mean that there is no back-to-back arrangement. Once the loan is deemed to have been made by the UPE directly to the Australian entity, other consequences, such as withholding tax payments and the effect of double tax agreements on the payment, will apply accordingly.

It is left to be seen how the "effective" obligation to pass on substantially the amount of the interest payment by the interposed entity to the UPE, would be applied. The Ruling does not provide examples to illustrate what would amount to an effective obligation to pass on the interest received by the interposed entity. This could result in a conflict arising between the Commissioner and the taxpayer in the future.

"Effective" obligation covers a wider area than any other taxpayer obligation. The "non-contingent" obligation in the debt equity distinction found in Division 974 of ITAA 1997 is not the same as effective obligation. The latter is wider in the sense that whether contingent or non-contingent, once the end result of the scheme was a back-to-back outcome, there is an effective obligation that the rule will apply.

## 8. Conclusion

Two significant issues that remain unresolved are the manner in which the rate of tax paid in the parent entity jurisdiction is to be calculated and what was the principal purpose in entering into the scheme to make the conduit payment of interest to the parent entity. It is difficult to envisage how the tax office could clearly state its position vis-à-vis the two issues at this stage. It is hoped that as things develop over the course of time, the cloud will lift, especially as the tax office deals with various scenarios arising with taxpayers.