

22 December 2017

**By email:**

**Exposure draft legislation on hybrid mismatches**

The Financial Services Council (FSC) welcomes the opportunity to make submissions on the draft legislation to address hybrid mismatches.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than \$2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

The FSC makes the following comments:

- We note hybrid mismatches can be caused by Australian tax rules. Our debt-equity rules are based on substance not form, while in many overseas jurisdictions instruments are classified based on form. As a result, the Australian debt-equity rules in some cases have created the very issues raised by this draft legislation.
- Generally, if the proposed rules alter the effective tax classification of an instrument, then the taxpayer should receive the beneficial effects of this change in classification, not just the punitive effects. For example:
  - If tax rules effectively reclassify an instrument as equity, then:
    - the instrument should be eligible to be counted as regulatory capital for life insurers
    - the instrument should be treated as equity instead of debt under the towards thin capitalisation rules
  - If an instrument is reclassified as debt, then it should be eligible for the withholding tax rates and exemptions that apply to debt.
- If the beneficial effects of effective reclassification are not permitted, then it is likely that most if not all taxpayers will wish to restructure instruments to stop the imposition of the hybrid mismatch rules. In this case, the government should provide a more substantial transition period for the rule changes to allow taxpayers to restructure. In the interim, anti-avoidance rules can be used to address any blatant misuse of hybrid mismatches.
- The overall objective of the exposure draft legislation is to eliminate hybrid mismatches. However, the proposed legislation may itself become an obstacle to doing this. This is because the mechanism in the exposure draft of denying deductions or including amounts in assessable income could result in taxpayers restructuring to eliminate hybrid mismatches triggering the anti-avoidance measures in Part IVA. For example, if payments on redeemable preference shares are denied deductions under the mismatch rules, replacing the redeemable preference shares with ordinary debt would result in interest deductions, and

prima facie this could trigger Part IVA. Therefore we submit that the legislation or explanatory material should specifically provide for restructures undertaken to eliminate hybrid mismatches.

- The imported hybrid mismatch rules may mean an Australian taxpayer is liable for tax because of the unknown actions of a third party. In some cases, the Australian entity may know about these actions, but this cannot be guaranteed in all cases. This does not appear to provide the Australian entity with the protections of due process. The FSC therefore considers this part of the proposal should be approached with substantial caution.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

[signed]

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