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Final report on BEPS Action 2: Neutralizing the effects of hybrid mismatch arrangements

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On October 5, 2015, ahead of the G20 Finance Ministers' meeting in Lima on October 8, the Organisation for Economic Co-operation and Development (OECD) Secretariat **published** thirteen papers and an Explanatory Statement outlining consensus Actions under the base erosion and profit shifting (BEPS) project. The output is intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the OECD Model Treaty and transfer pricing guidelines. They are broadly classified as "minimum standard", "best practices" or "recommendations" for governments to adopt. The OECD will be continuing its work on some specific follow-up areas in future years.

As part of the 2015 output, the OECD has published a final report on Action 2 in relation to neutralizing the effects of hybrid mismatch arrangements, which proposes domestic and treaty changes.

Deloitte's comments

It is relatively common for Canadian and foreign multinational enterprises to have hybrid entities or instruments within their groups. Developments in this area are therefore likely to be of wide interest.

The examples that are included in the report are helpful for tax authorities and taxpayers but demonstrate the potential complexity of the rules. In addition, the main recommendations are domestic measures and, therefore, it will depend on if and when countries choose to implement the new rules as to how groups may be impacted. At this stage, it is difficult for groups to assess whether the primary, secondary or imported rules could apply and it may be necessary to model the possible effect under various scenarios. For some groups, this may be only the first stage in the process as they may also be required to consider the other BEPS final reports, in particular BEPS Action 4, *Interest Deductions and other Financial Payments*.

OECD proposals

The proposals contained in the final report are broadly in line with the interim report released in September 2014. The recommendations are designed to neutralize mismatches by targeting the following types of arrangement: deduction/no inclusion

(D/NI) outcomes, double deduction (DD) outcomes and indirect deduction/no inclusion (Indirect/NI) outcomes.

The final report includes 80 examples to supplement the recommendations in Part I and provide further guidance on how the rules will operate in practice. Although the design principles indicate that the rules should be clear and transparent and minimize compliance costs, some of these examples demonstrate that the rules will be necessarily complex. The report notes that the hybrid mismatch rules would apply before any general or overall limitation on income or expenses, including interest limitation rules, which could be included in domestic rules as a result of Action 4. Further work has been undertaken on asset transfer transactions (e.g., stock lending and sale and repurchase transactions (repos)), imported hybrid mismatches and the interaction with controlled foreign corporation (CFC) regimes.

Recommendations

Specific hybrid mismatch rules are recommended to address each of these arrangements. The recommendations are in the form of "linking" rules to be adopted within domestic legislation: a primary rule (denying a deduction) and a secondary rule, to apply in circumstances where the primary rule does not apply.

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D / NI	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	Controlled 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	-	Controlled group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response; defensive rule applies to controlled group and structured arrangements
	Deductible payment made by a dual resident		Deny resident deduction	-	No limitation on response
Indirect D / NI	Imported mismatch arrangements		Deny payer deduction	-	Members of a controlled group and structured arrangements

Hybrid financial instrument rule – specific points

Payee/payer jurisdiction can be the same

Although D/NI outcomes most commonly arise where the payer and payee jurisdictions are different, the report notes that this is not a requirement of the rules.

Income subject to a reduced rate/partial exemption

The report clarifies that a mismatch will not arise simply because a country generally taxes income from all financial instruments at a lower rate than other types of income.

Where the income is partially exempt or only a particular type of income (e.g., dividend income) is subject to tax at a reduced rate, proportionate adjustments should be made to neutralize the mismatch.

Payments

The financial instrument rule applies to substitute payments and payments to the extent that those payments give rise to a D/NI outcome. "Payment" is defined in Recommendation 12 as "any transfer of value and includes an amount that is capable

of being paid", such as a future or contingent obligation to make a payment. Payments that are only deemed to be made for tax purposes are specifically excluded as they do not involve the creation of any new economic rights between the parties. Therefore, for example, the rules are not intended to apply to interest-free loans on which a deemed interest deduction is available in the borrower's jurisdiction.

The examples provide guidance on items which are intended to be included and excluded under this definition. In particular, the forgiveness of a debt is a transfer of value between two entities. However, it is not a "payment". In addition, foreign exchange differences are not included, as the gains and losses are attributable to the way jurisdictions measure the value of money rather than the value of the payment itself.

CFC income

The recommendations are not intended to give rise to economic double taxation. In certain cases, a payment under a hybrid financial instrument that gives rise to a D/NI outcome may be included in the income of a parent under a CFC regime. To avoid economic double taxation, consideration should be given as to whether a payment has already been included under a CFC regime. A taxpayer seeking to rely on the inclusion should only be able to do so in circumstances where it can satisfy the tax administration the payment has been fully included under the laws of the relevant jurisdiction and is subject to tax at the full rate.

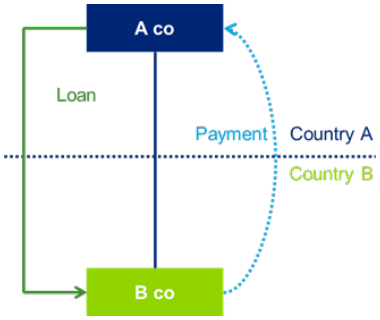
The rules that determine income included under a CFC regime can make the determination of whether an amount has been included in ordinary income difficult and based on the specific facts and circumstances. Accordingly, the report recommends that materiality thresholds must be carefully considered before treating a CFC inclusion as reducing the amount of adjustment required under the financial instrument rule.

Timing differences

The financial instrument rule does not generally apply to timing differences. The report recommends that a payment should not be treated as giving rise to a D/NI outcome if the tax administration can be satisfied that the payment under the instrument is expected to be included in income within a reasonable period of time. A payment can expected to be included in income where there was a reasonable expectation at the time the instrument was issued that the payment would be made and that the payment would be included in ordinary income by the payee at the time it was paid. The determination of whether this payment will be made within a reasonable period of time should be based on the time period that might be expected to be agreed between unrelated parties acting at arm's length.

The report recommends a safe harbour – a payment should not be treated as giving rise to a mismatch if it will be required to be included in the payee's ordinary income in an accounting period that commences within 12 months of the end of the payer's accounting period.

Interest payment to an exempt person (Example 1.5)



- Both jurisdictions treat the loan as a debt instrument. A co is a sovereign wealth fund that is exempt from tax on all income and is therefore not taxable on the interest income.

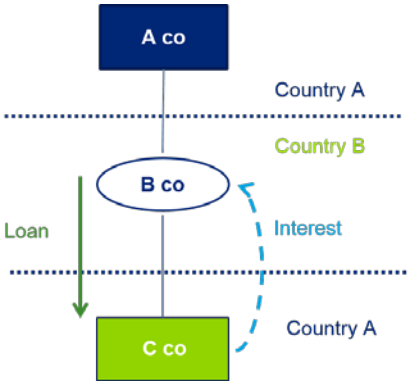
The payment of interest under the loan gives rise to a mismatch in tax outcomes. This D/NI outcome will not, however, be treated as a hybrid mismatch unless it can be attributed to the terms of the instrument.

If the mismatch in tax outcomes would not have arisen had the interest been paid to a taxpayer of ordinary status, then the mismatch will be solely attributable to A co's status as a tax exempt entity, and cannot be attributable to the terms of the instrument itself. Consequently, the mismatch in tax outcomes will not be caught by the hybrid financial instrument rule.

If the terms of the instrument would bring about a mismatch in tax outcomes (i.e., the payment would not have been included even if it had been made to an ordinary taxpayer) then the mismatch will be treated as a hybrid mismatch and subject to a potential adjustment under the hybrid financial instrument rule.

There are other examples considering payments to persons established in a no-tax jurisdiction or which operate full territorial tax regimes. The rules will not apply in these circumstances.

Interest payment to a tax exempt permanent establishment (PE) (Example 1.8)



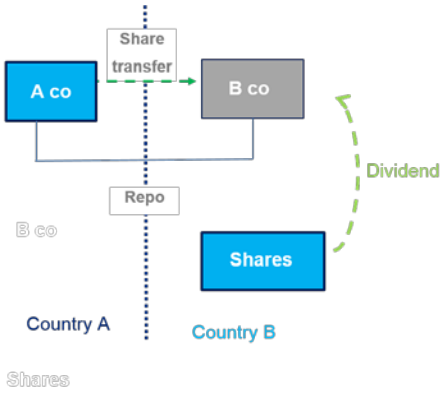
- A co lends to C co (a wholly owned subsidiary) through a PE in Country B. All the countries treat the loan as a debt instrument for tax purposes.
- Payments of interest under the loan are deductible under Country C law but not included in income under Country A law. Country A provides an exemption for income derived through a foreign PE.

The payment of interest will give rise to a D/NI outcome if the payment is not treated as ordinary income under both Country A and B laws.

A deductible payment that gives rise to a mismatch in tax outcomes will be treated as falling within the hybrid financial instrument rule if the mismatch can be attributed to the tax treatment of the instrument under the laws of Country A or B.

A mismatch in outcomes will not be treated as a hybrid mismatch if it is solely attributable to the circumstances in which the instrument is held. If the mismatch is attributable to the terms of the instrument, rather than the status of the taxpayer or the context in which the instrument is held, then the mismatch should be treated as a hybrid mismatch within the scope of the rule (e.g., if the income on the loan is treated as an exempt dividend).

Loan structured as a share repo (Example 1.31)



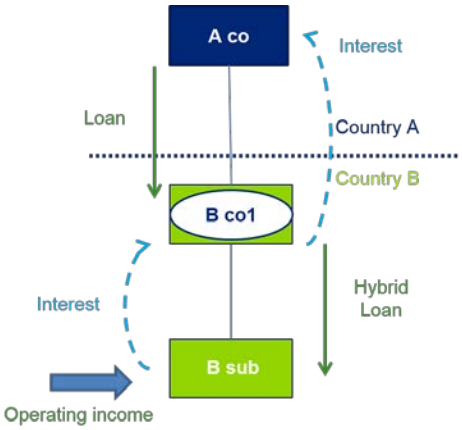
- A co borrows money from B co.
- A co transfers shares to B co under an arrangement whereby A co (or an affiliate) will acquire those shares at a future date for an agreed price that represents a financing return minus any distributions received on the B co shares during the term of the repo.

The repo is a hybrid transfer and the payment of the dividend on the underlying shares gives rise to a D/NI outcome. This mismatch is a hybrid mismatch because it is attributable to the difference in the way Country A (deductible expense under the repo) and B (exempt return on the underlying shares) characterize and treat the payments under the repo.

Disregarded hybrid payments rule

A deductible payment can give rise to a D/NI outcome where the payment is made by a hybrid entity that is disregarded under the laws of the payee jurisdiction. In order to be a disregarded payment, the payment must be deductible under the laws of the payer jurisdiction. These include expenditure such as service payments, rents, royalties, interest etc. The term does not, however, cover the cost of acquiring a capital asset or an allowance for depreciation or amortization.

Disregarded hybrid payment structure using a disregarded entity and a hybrid loan (Example 3.1)



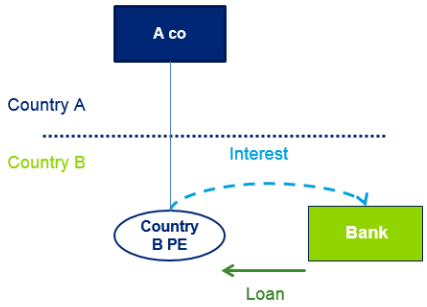
- B co1 is a hybrid entity (i.e. treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law).
- B sub is treated as a separate taxable entity under Country A and Country B laws.
- B Co1 borrows money from A Co. B Co1 on-lends that money under a hybrid loan.
- Interest payments on the loan are treated as ordinary income under Country B law but as exempt dividends under Country A law.

The financial instrument rule will not apply to the interest payment on the hybrid loan because the interest does not give rise to a D/NI outcome (as it is included in income under the laws of Country B). However, the fact that B co1 is disregarded as a separate entity under the laws of Country B means that the deductible interest payment that B co1 makes to A co is disregarded under Country A law and, accordingly, will be caught by the disregarded hybrid payments rule in Recommendation 3. The payment of interest on the hybrid loan does not constitute dual inclusion income because it is not included in ordinary income under the laws of Country A.

Deductible hybrid payments and dual resident tax payer rule

The Report notes that some of the structures that give rise to DD outcomes in respect of payments can also be used to generate double deductions for non-cash items such as depreciation or amortization. A DD outcome raises the same tax policy issues, regardless of how the deduction has been triggered, and distinguishing between deductible items on the basis of whether they are attributable to a payment would complicate rather than simplify the implementation of these recommendations. Accordingly, when implementing domestic law changes, countries may wish to apply the recommendations to all deductible items regardless of whether they are attributable to a payment.

Whether DD may be offset against dual inclusion income (Example 6.2)



- A co establishes a PE in Country B.
- PE borrows money from a local bank.
- Interest on the loan is deductible in both Country A and Country B.
- The PE has no other income.

A co falls within the definition of a “hybrid payer” as it is a non-resident making a payment of interest which is deductible under the laws of Country B (the payer jurisdiction) and which triggers a duplicate deduction for A co under the laws of Country A (the parent jurisdiction). While income of the PE would presumably be taxable under the laws of both Country A and B, the payment will give rise to a DD outcome because the PE has no other income against which the deduction can be offset. DD outcome will give rise to a hybrid mismatch if the deduction is capable of being set off against non-dual inclusion income under Country B law. It is not necessary for a tax administration to know how the deduction has been used in the other jurisdiction before it applies the rule.

The primary rule operates to restrict a deduction in the parent jurisdiction, even in circumstances where the deduction has not been utilized in the payer jurisdiction. As a result, the deductible hybrid payments rule has the potential to generate “stranded losses” (e.g., where A co abandons its operations in Country B and winds up the PE). Recommendation 6.1(d)(ii) provides that Country A’s tax administration may permit those excess deductions to be set off against non-dual inclusion income under the laws of Country A provided the taxpayer can establish that Country B will prevent A co from using those losses in Country B. For example, if a Canadian company owned by a US parent is disregarded, but the parent certifies to the IRS that the losses of the Canadian company will not be used to set off against another entity’s income, this exception may be met.

Imported mismatch rule

Although the recommendations are intended to be implemented through domestic law in all participating countries, they are designed to work effectively even if this is not achieved. It is possible for groups to have a hybrid mismatch arrangement between two countries which do not introduce the rules, and then transfer the benefit to a third country using an arrangement that does not give rise to a hybrid mismatch. The imported mismatch rules, if adopted in the third country, would deny a deduction in that country.

The proposed rules involve an unavoidable degree of coordination and complexity, as the guidance sets out three tracing and priority rules to be used to determine the extent to which a payment should be treated as a set-off against a deduction under

an imported mismatch arrangement. This area is one of the most complex of the report and there are a number of examples included in Annex B.

Treaty provision on transparent entities

The 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnerships* contains an analysis of the application of treaty provisions to partnerships, including where there is a mismatch in the tax treatment of the partnership. However, it did not expressly address the application of tax treaties to entities other than partnerships. In order to address this issue, it was decided to include in the OECD Model Tax Convention a provision and Commentary which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the OECD Partnership report. This will ensure that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither contracting state treats the income of an entity as the income of one of its residents under its domestic law.

Transitional rules and losses under the imported mismatch rule

There are no transitional rules contained in the report and it is generally expected that the rules should apply to payments made after the rules are brought into effect.

In respect of the imported mismatch rules, it is noted that in order to account for timing differences and to prevent groups from manipulating that timing in order to avoid the effect of the imported mismatch rule, a hybrid deduction should be taken to include any net loss that has been carried forward to a subsequent accounting period, to the extent that the loss results from a hybrid deduction. In order to reduce complexity, it is recommended that any losses carried forward from periods ending on or before December 31, 2016 should be excluded from the operation of this rule.

Next steps

It is expected that the G20 leaders will give final approval to the content of the papers in November 2015.

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