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OECD BEPS Action 2: Hybrid mismatch arrangements

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The Organisation for Economic Co-operation and Development (OECD) released two discussion drafts for public comment on March 19, 2014 as part of its base erosion and profit shifting (BEPS) Action Plan in relation to Action 2, Hybrid Mismatch Arrangements. The drafts cover recommendations for changes to domestic laws to neutralize hybrid mismatch arrangements and recommendations for changes to the OECD Model Tax Convention.

As with other discussion drafts on BEPS Actions, the proposals do not represent a consensus view from the OECD/G20 countries involved.

Recommendations for domestic law changes

The recommendations in the discussion draft target three categories of hybrid mismatch arrangements:

- **Hybrid financial instruments (including transfers)** - where a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction;
- **Hybrid entity payments** - where differences in the characterization of the hybrid payer result in a deductible payment being disregarded or triggering a second deduction in the other jurisdiction; and
- **Reverse hybrid and imported mismatches** – where payments made to an intermediary are not taxable on receipt due to a hybrid effect.

The proposals attempt to neutralize hybrid mismatch arrangements on a unilateral basis, without reliance on a counterparty jurisdiction.

Hybrid financial instruments and transfers

The first category of hybrid arrangements involves the use of hybrid financial instruments, which would be defined to include any financing arrangement that is subject to a different tax characterization in two or more jurisdictions such that a payment under the instrument gives rise to a mismatch in tax outcomes. A typical example is an instrument (such as a profit participating loan) that is viewed as debt in the payer jurisdiction and equity in the payee jurisdiction with payments giving rise to deductible interest for the payer and exempt dividend income for the payee.

The discussion draft recommends that no exemption, exclusion or tax credit should be available in the payee jurisdiction for payments that are deductible in the payer jurisdiction. This would obviate the need for a mismatch rule in many cases, as the payment would be included in the ordinary income of the payee. However, if a hybrid instrument payment is not included in the ordinary income of the payee, the discussion draft recommends a “primary rule” that would apply to deny the deduction in the payer jurisdiction. If the payer jurisdiction has not enacted such a rule, a “secondary” or “defensive rule” would apply to require the payee jurisdiction to include the payment in income. The definition of a hybrid financial instrument would also include certain hybrid transfer arrangements such as “repo” transactions.

The discussion draft acknowledges that not all hybrid financial instruments should be caught by the rules. It recommends that the rule should apply to all instruments held by related parties as well as structured arrangements designed to produce a mismatch, but should generally not apply to the issuer of a widely-held instrument. The discussion draft seeks input on the best approach to achieve these objectives.

The proposed rules are intended to target only those instruments that are hybrid for tax purposes. The possibility of other hybrid effects (for instance, for regulatory or accounting purposes) does not impact the analysis of whether the instruments or arrangements are hybrid for tax purposes. Thus, for example, third party debt raised by a financial institution on terms which enable the debt to be treated as capital for regulatory purposes, but as debt for tax purposes, is not intended to be impacted by these proposals.

The discussion draft notes that instruments issued by financial institutions directly to the market are unlikely to be within the scope of the proposed rules. However, issues arise with respect to intercompany arrangements entered into to pass such financing down from a top holding company to operating subsidiaries. Therefore, the document states that a coordination rule which allows the tax effect of the issuer’s deduction to be passed down through chains of related parties to the ultimate borrower could be considered.

Hybrid entity payments

The second type of hybrid arrangement exploits differences in entity or arrangement characterization between two jurisdictions to produce a double deduction or a deduction and no inclusion in respect of payments made by that entity.

An example of a double deduction would be a payment made by an entity that is deductible in two jurisdictions, either due to the hybrid nature of the entity or circumstances such as dual residency or the application of tax consolidation rules. In the case of double deductions, the proposals recommend the application of a primary rule that would deny the deduction in the investor country to the extent that it exceeds the amount of income included for tax purposes under the laws of both countries (“dual inclusion income”). Further, a secondary or defensive rule would deny the deduction to the subsidiary if the primary rule does not apply in the investor country. Denied deductions could be carried forward and applied against future dual inclusion income.

An example of a deduction and no inclusion structure would be a payment by a subsidiary located in one country to its parent company in a second country where the payment is disregarded in computing the parent’s income because the entity is viewed as fiscally transparent under the tax laws of the parent’s country of residence. This would include a payment from a fiscally transparent Canadian unlimited liability company to its US parent, a structure already addressed by Article IV(7)(b) of the Canada-US tax treaty. Unlike the treaty article, which denies treaty benefits for such payments, the primary rule under these proposals would target the payer of such amounts and deny the deduction to the subsidiary to the extent that it was greater than the subsidiary’s dual inclusion income for the same period. The secondary rule, which would apply if the country of the subsidiary did not enact such a rule, would require the parent to include the disregarded payment in income to the extent that the subsidiary's deductions exceed its dual inclusion income.

Similar to the proposals with respect to hybrid financial instruments, it is proposed that the hybrid entity rule cover mismatches between related parties and structured arrangements. The discussion draft notes that hybrid entities that are widely held are unlikely to have sufficient information as to the identity and tax treatment of their investors in order to apply the rules. However, investors should be able to apply the rules since they should have sufficient information about the hybrid entity.

Reverse hybrids and imported mismatches

The final category of hybrid arrangements includes payments made to an entity that are deductible in one country but do not result in an income inclusion in another country due to the reverse hybrid nature of the recipient or certain hybrid arrangements involving third country intermediaries. A "reverse hybrid" for purposes of the discussion draft is an entity that is viewed as a corporation or other opaque entity by its foreign owner and a fiscally transparent entity in the jurisdiction where it is established.

Typically, a deductible payment is made to the reverse hybrid that is not taxable in the jurisdiction where it is located or in the jurisdiction of its owner. Such structures were previously addressed in the Canada-US context by Article IV(7)(a) of the treaty. Unlike the treaty article, which denies treaty benefits in respect of such payments, the primary remedy under these proposals would be to impose domestic taxation of the payment on the investor, either directly or through controlled foreign corporation (CFC) rules (such as the Canadian foreign accrual property income (FAPI) rules and the US subpart F rules). This proposed rule is not restricted to payments from related parties. The secondary rule would treat the payment as taxable in the intermediary jurisdiction if the primary rule does not apply, but only if a controlling shareholder treats the intermediary as a reverse hybrid. Lastly, if neither of the relevant countries enacts such rules, the country of the payer should generally deny the deduction where the payer is part of the same control group or has incurred the expense as part of an avoidance arrangement.

The discussion draft also recommends the imposition by intermediary countries of tax filing and information reporting requirements to facilitate the ability of offshore investors and tax administrations to determine the income and gains derived by the intermediary and the amounts beneficially owned by each investor.

"Imported mismatches" use a third country intermediary to avoid taxation in the investor country. For example, an investor finances the intermediary through a hybrid instrument and the intermediary makes an ordinary loan to the investee. Interest paid by the borrower is offset in the third country by a deduction in respect of payments on the hybrid instrument. The discussion draft notes that the enactment of comprehensive hybrid mismatch rules in the investor or intermediary country should discourage the use of such structures. However, if no such rules are implemented, it is recommended that the country of the payer enact rules to deny the deduction where the payer is part of the same control group as the parties to the mismatch or is party to an avoidance arrangement.

The proposals in this third category would seem to apply even in circumstances where the income of the intermediary would otherwise be deemed to be active business income under the FAPI rules or similar CFC rules, and thus excluded from immediate taxation in the investor country.

Discussion draft on treaty issues

The second discussion draft considers treaty issues related to dual resident entities and hybrid entities, and discusses the interaction between the recommendations in the first discussion draft and tax treaties.

The BEPS Action 6 discussion draft concerning treaty abuse has recommended that the OECD Model Convention be amended to resolve dual residency issues on a case-by-case basis rather than on the basis of the place of effective management. In addition to that recommendation, this discussion draft recommends that countries include provisions in their domestic law, as Canada does, to deem an entity that is not a resident of the particular country under a tax treaty not to be a resident under domestic law.

The discussion draft also includes a proposal for a new OECD Model Convention provision which sets out that an entity that is fiscally transparent under the tax laws of either country will be treated as if it is resident in the recipient country for the purpose of accessing the treaty, but only to the extent that the recipient country, in its domestic law, treats the entity as a resident in respect of the income concerned (and therefore taxes it).

Timetable and next steps

The OECD has requested comments on the two discussion drafts by May 2, 2014. A public consultation event will be held at the OECD in Paris on May 15, 2014 before finalization at the G20 meeting on September 20-21, 2014.

Deloitte's comments - issues to consider

One of the challenges with hybrid arrangements has always been the identification of which country is being disadvantaged. The OECD has tackled this concern head-on with its view that a hybrid mismatch should be countered without asking the question at all.

If adopted by Canada and other countries, the proposals would have a dramatic impact on Canadian companies, as many structures commonly used by foreign companies to finance Canadian subsidiaries, and by Canadian companies to finance foreign subsidiaries involve hybrid instruments and/or hybrid entities.

Certain hybrid entity structures involving related US companies were impacted by the introduction of Article IV(7) of the Canada-US tax treaty, effective as of 2010. However, those changes did not affect hybrid instrument arrangements and many hybrid entity structures continued to be in compliance with the treaty changes. All of those structures may be negatively affected by this proposal, if adopted. It is also unclear how the domestic law changes would interact with the treaty article. It would be necessary to ensure that the treaty and domestic law measures did not apply in tandem to result in double taxation.

With respect to hybrid financial instruments, the proposals do not address the difficulty in determining whether an arrangement is debt or equity under the laws of a jurisdiction. In the United States, in particular, this is a difficult exercise based on the facts and circumstances. It is unclear how the rules could be effectively administered in such cases.

Many Canada/US structures involving financing through third country intermediaries may also be affected, either by this proposal where a hybrid arrangement is used, or by Canada’s anti-treaty shopping proposals and the BEPS proposals on treaty shopping in Action 6. While we do not recommend immediate action to change existing structures, all cross-border financing arrangements between Canada and the United States should be reviewed to determine the potential impact of the various BEPS proposals.

In addition to hybrid financing transactions involving related US companies, hybrid investments made by Canadian companies in subsidiaries in other countries including Australia and Luxembourg, and hybrid investments in Canadian subsidiaries from a number of countries, including the Netherlands and Germany, are also potentially affected.

Note that the proposals only apply to hybrid arrangements (although broadly defined), and only to those involving a “payment”. The discussion draft clearly states that the proposals do not extend to payments that are deemed to arise for tax purposes. For example, some jurisdictions provide a deemed or notional deduction for interest-free loans or royalty-free licenses. It is possible, however, that such tax rules may be the subject of other BEPS proposals.

The proposals raise difficult issues in terms of both policy and application. Canadian governments, for example, have long supported our exempt surplus rules and rules that deem deductible inter-affiliate payments to be excluded from FAPI on the basis of supporting the international competitiveness of Canadian multinational enterprises. If adopted, these proposals would significantly erode that policy.

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