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Tax Analysis

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BEPS Action 2: Hybrid mismatch arrangements

On 16 September 2014, ahead of the G20 Finance Ministers' meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting (BEPS) Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

Deloitte comments

The recommendations seek to address a number of concerns raised in consultation - but it remains clear that, where implemented, the proposals will impact many widely used hybrid financing arrangements. The OECD will develop a Commentary by September 2015 to aid countries in implementing the new rules.

The focus on structured arrangements and related party/controlled group helps strike a balance between compliance costs and neutralising the tax benefit from mismatches. The move to a 25% threshold (rather than 10%) addresses concern that tax authorities and taxpayers will find it difficult to obtain information to conclude whether a structure could be a hybrid mismatch arrangement.

We hope clarity will be provided as soon as possible on the substantive open points, to reduce uncertainty and to limit unilateral measures that may result in double taxation. This is of particular importance to the banking and insurance sectors where there is concern that the recommendations could have a disproportionately negative effect.

The recommendations are designed for translation into domestic legislation and tax treaties. Given the unresolved substantive issues and the need for implementation guidance, it seems unlikely that any country will begin implementation prior to publication of the Commentary in September 2015. Consideration will be given as to whether a number of jurisdictions can agree to introduce provisions that are effective from a common date. The widespread and timely implementation of consistent rules will be the key to effectively tackling the hybrid mismatch arrangements the Action seeks to target and the proposed Commentary is essential to achieving this.

OECD Proposal

The recommendations are designed to neutralise mismatches by targeting the following types of arrangement:

Deduction/No Inclusion (D/NI) outcomes

- *Hybrid financial instruments* - a deductible payment made under a financial instrument (including a hybrid transfer such as a repo) is not treated as taxable income under the laws of the recipient's jurisdiction;

- *Disregarded hybrid payments* - differences in the treatment of the hybrid payer result in a deductible payment being disregarded in the other jurisdiction; and

- *Reverse hybrids* - payments made to an intermediary are not taxable on receipt due to a hybrid effect.

Double Deduction (D/D) outcomes

- *Deductible hybrid payments* - a deductible payment by a hybrid payer which result in a second deduction in a parent jurisdiction; and

- *Deductible payments made by dual residents* - deductible payments made by a dual resident entity trigger a second deduction in the other jurisdiction.

Indirect Deduction/No Inclusion (Indirect D/NI) outcomes

- *Imported mismatch arrangements* - the effect of a hybrid mismatch that arises between two jurisdictions can be shifted (or imported) into another jurisdiction through the use of a plain-vanilla financial instrument.

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, to apply whenever a mismatch arises (primarily denying a deduction) and, a secondary or defensive rule, to apply in circumstances where the primary rule does not apply (generally to tax income). This approach seeks to align the tax treatment of an instrument or entity with the tax outcomes in the counterparty jurisdiction on a standalone basis, without reliance on counterparty jurisdictions. To avoid double taxation, a hierarchy operates to switch-off the effect of one rule where there is a rule in the counterparty jurisdiction which addresses the mismatch.

Further changes to domestic law are recommended to align better domestic and cross-border outcomes: restricting dividend exemptions for deductible payments; limitation of tax credits for taxes withheld at source; improvements to Controlled Foreign Company (CFC) and other offshore investment regimes; restricting the tax transparency of reverse hybrids that are members of a controlled group; and information reporting requirements.

Scope

Each hybrid mismatch rule has its own defined scope which seeks to achieve a balance between a rule that is comprehensive, targeted and administrable. Broadly, the rules target structured arrangements and related party/controlled group transactions. In response to concerns in respect of obtaining information from minority stakeholders, the related party definition applies where there is a 25% (rather than 10%) investment. The hybrid entity rules apply to controlled groups, which includes those groups consolidated for accounting purposes.

Further work is required in respect of imported mismatch arrangements and the need to clarify whether or not income taxed under a CFC regime should be treated as included in ordinary income. The OECD acknowledges countries may in the meantime make their own policy choices.

Banking and Insurance - Regulatory capital

A key concern raised during the consultation process was the application of the rules to hybrid regulatory capital issued intra-group. Further work is required to clarify whether special treatment is justified.

Treaty issues

A new model treaty provision is recommended which sets out that a recipient 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). The work undertaken in respect of BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances addresses some issues in respect of dual resident entities.

Timetable and Next Steps

Guidance, in the form of a detailed Commentary to enable domestic adoption, will be issued no later than September 2015. The Commentary will explain how the rules would operate in practice, including practical examples, and set out transitional rules if there are differing dates of implementation. In addition, work will continue in respect of the outstanding substantive points (certain capital market transactions (including on market stock lending and repos), imported mismatches and CFC inclusion) with a view to reaching consensus and publishing the recommendations along with the Commentary. Further input will be sought from stakeholders.

It will be necessary to consider the implications of recommendations made in respect of Action 3- Strengthen Controlled Foreign Company rules and Action 4- Limit Base Erosion via interest deductions and other financial payments.

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