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International Tax

# OECD Tax Alert

15 March 2013

## New report sees dangers in after-tax hedging transactions


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In a report issued on 13 March 2013, the OECD alerts tax authorities worldwide of the potential for aggressive tax planning (ATP) in situations where taxpayers factor in the tax effect of hedging transactions ("after-tax hedging"). The report, entitled "*Aggressive Tax Planning based on After-Tax Hedging,*" describes the features of ATP schemes, the challenges arising from such schemes and the tools that can be used by governments to detect and respond to ATP schemes.

The OECD Steering Group on ATP was established in 2007. Since that time, the OECD has set up the ATP directory (a database accessible only to tax authorities) and has published several reports: "*Tackling Aggressive Tax Planning through Improved Transparency and Disclosure*" (2011), "*Corporate Loss Utilization through Aggressive Tax Planning*" (2011)), "*Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*" (2012) and "*Addressing Base Erosion and Profit Shifting*" (BEPS).

The after-tax hedging report acknowledges that hedging and after-tax hedging (where the tax effect is factored in) are not necessarily aggressive *per se*. After-tax hedging will be considered aggressive only when the scheme concerned is artificial and designed to allow a taxpayer to achieve a higher return without assuming any risk, thereby shifting the risk to the government. Such schemes can negatively impact a country's tax base, and the report notes that there is empirical evidence that hundreds of millions of dollars (USD) are at stake.

The report appears to be in the nature of a wake up-call and does not propose any concrete solutions to the perceived problem. That is, the aim of the report is to ensure that tax authorities are aware of potential schemes involving after-tax hedging and to issue a warning that any country is exposed where there is a mismatch between the taxation of the hedged risk and the hedging instrument. As in other case, the targeted response is to be left to individual countries.

The report provides examples of cases in which the hedged transaction/risk and the hedging instrument are taxed differently and where potential ATP could arise; for example, where an investment in shares serves as the hedging instrument to hedge the currency exchange risk in the context of a currency carry trade (i.e. where an investor sells a low interest rate currency and uses the proceeds to purchase a higher interest rate currency). The scheme exemplified here relies on the difference between the tax treatment of the hedged transaction/risk and that of the hedging instrument (disparity). Some schemes additionally rely on an asymmetry inherent in the different treatment of the hedging instrument itself, dependent on whether a gain or loss is made. The report illustrates the effect of after-tax hedging via examples that use actual numbers.

The after-tax hedging report addresses itself to tax administrations and describes various means by which they may detect ATP schemes (once identified, an ATP scheme is added to the ATP directory). The means envisaged include information provided by taxpayers in ruling requests, information uncovered during audits, intelligence that comes to light in the ordinary dialogue between taxpayers and the tax administration, items reported under mandatory disclosure rules and, finally,  information that emerges in the context of enhanced taxpayer/tax administration relationships.

Significantly, the report does not actually answer the fundamental question: at what point do after-tax hedging transactions become ATP? In acknowledging the difficulty of distinguishing between what is and is not an acceptable transaction, the report confines itself to indicating that this will depend on facts and circumstances of, and the commercial rationale for, the transaction concerned. The report also recognizes that after-tax hedging (which is described in the report in a purely domestic context) becomes more complicated when a cross-border dimension is added. The report goes no further than suggesting that domestic tax departments need to have sufficient resources and expertise in the area, if only to recognize the existence of hedged transactions/risks.

As regards the strategies that tax authorities may adopt in response to ATP involving after-tax hedging, the report mentions the exercise of behavioral influence over taxpayers and scheme promoters, as well the application of transfer pricing rules, general anti-avoidance rules and specific anti-avoidance rules. Since counter measures must be appropriate to the domestic situation of each country, the report is not able to suggest a more detailed approach.

The publication of the report clearly demonstrates that aggressive forms of after-tax hedging have attracted the OECD’s attention. It is suggested that OECD member countries should regard this kind of ATP as a serious issue.