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International Tax

United States Tax Alert

April 4, 2014

OECD Releases BEPS Draft on Hybrid Mismatch Arrangements

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On March 19, 2014, the OECD released a public discussion draft on Action 2 of its Action Plan on Base Erosion and Profit Shifting (BEPS). Comments on the draft are to be sent to the OECD by Wednesday, May 2, 2014. It is important to note that the recommendations set out in the discussion draft do not necessarily represent the consensus views of the Committee on Fiscal Affairs or of Working Party No. 11 on Aggressive Tax Planning.

The OECD's Action 2 of BEPS is focused on mitigating the impact of a "mismatch in tax outcomes" resulting from dissimilarities inherent in foreign law with respect to complex financial arrangements and business entities. In doing so, the OECD does not address the broader economic impact of its proposals which recommend a denial of deductions or exclusions or require inclusions of income in jurisdictions where, for example, capitalization through debt has preferential treatment compared to equity. By denying a deduction for interest expense with respect to the funding of a particular capital investment, the rate of return derived from that business enterprise is reduced, thereby making the investment less attractive. The interest deduction represents a tax expenditure made by the investee jurisdiction to attract capital investment and the corresponding economic growth. A broader lens may be used in evaluating an accurate cost/benefit analysis associated with addressing the taxation of cross border financing. Such an analysis has already caused some countries to pull back from original proposals to restrict deductions on cross border financing.

The discussion draft is split into two papers. The first recommends domestic rules that address hybrid mismatch arrangements. The second develops and recommends treaty provisions to neutralize the effect of hybrid instruments and entities.

Recommendations for Domestic Law

The discussion draft describes a hybrid mismatch arrangement as "a profit shifting arrangement that utilises [sic] a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement." The goal of the discussion draft is to recommend domestic rules governing hybrid mismatch arrangements which would:

(a) Prevent exemption or non-recognition for payments that are deductible by the payer;

(b) Deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); and

(c) Deny a deduction for a payment that is also deductible in another jurisdiction.

Hybrid Mismatch Arrangements

The OECD defines a hybrid mismatch arrangement as a profit shifting arrangement that utilizes a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement. The key elements of a hybrid mismatch arrangement under the discussion draft are:

(a) The arrangement results in a mismatch in the tax treatment of a payment.

(b) The arrangement contains a hybrid element.

(c) The hybrid element is the cause of the mismatch.

(d) The mismatch in tax outcomes lowers the aggregated tax paid by the parties to the arrangement.

The two principal mismatches identified are payments that are deductible under the rules of the payer and not included in the income of the recipient (deduction/no inclusion or D/NI) and payments that give rise to multiple deductions from the same item (double deduction or DD). The D/NI and DD arrangements described must involve a payment. Therefore, deductions granted by a particular jurisdiction's tax law which do not involve a payment are outside the scope of the recommended domestic rules.

Also out of the scope of the recommended rules are arrangements with payments that are deductible under the payer's taxing jurisdiction but are subject to tax as ordinary income in the recipient's taxing jurisdiction. Income is includible as "ordinary income" when "the payment has been incorporated into a calculation of the recipient's net income under the laws of the relevant tax jurisdiction." This is true even if the recipient is exempt from tax on ordinary income or a jurisdiction imposes a "nil marginal rate" of tax on ordinary income.

Categories of Hybrid Mismatch Arrangements

The discussion draft targets three categories of hybrid mismatch arrangements:

(a) *Hybrid financial instruments and transfers*, where a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction;

(b) *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;

(c) *Reverse hybrids and imported mismatches*, which cover payments made to an intermediary payee that are not taxable on receipt. There are two kinds of arrangement targeted by these rules:

i. Arrangements where differences in the characterization of the intermediary result in the payment being disregarded in both the intermediary jurisdiction and the investor's jurisdiction (reverse hybrids)
ii. An arrangement where the intermediary is party to a separate hybrid mismatch arrangement and the payment is set off against a deduction arising under that arrangement (imported mismatches)

With respect to each category of hybrid mismatch arrangements described above, the discussion draft (i) describes the arrangement or structure, (ii) provides a summary of domestic law change recommendations with a technical discussion, (iii) applies the recommendation to the arrangement or structure, and (iv) discusses the intended scope of the recommendation.

The discussion draft recommends the use of "linking rules" to help ensure the avoidance of mismatch arrangements without the need to rely on corresponding rules in another taxing jurisdiction. Thus, for each arrangement, the discussion draft recommends a "primary" rule when a mismatch is identified, and a "secondary" or "defensive" rule which would apply in circumstances where the primary rule does not.

Hybrid Financial Instruments and Transfers

The discussion draft defines a hybrid financial instrument as any financing arrangement that is subject to different tax characterization under the laws of two or more jurisdictions such that the payment gives rise to a mismatch in tax treatment. A primary example of this is a financial instrument, the payment on which is deductible as debt in one taxing jurisdiction and taxed as a dividend distribution in another taxing jurisdiction. The mismatch resulting from hybrid financial instruments and transfers leads to D/NI outcomes.

It should be noted, however, that the scope of the proposal is unclear in a case in which there is a timing difference between the recognition of income and the recognition of the deduction. The proposal states that it does not cover a case where an interest deduction is accrued on an original issue discount (OID) instrument, but the income recognition by the holder does not occur until the bond is redeemed. This raises the question of how a hybrid debt/equity instrument would be treated if the issuer's jurisdiction allows accrual of interest expense and the holder's jurisdiction taxes the income received from the instrument as a dividend. This represents a timing difference, but it is not clear that, due to the difference in character of the income in the different jurisdictions, it would be excluded from the proposed denial of deduction under the proposal.

With respect to hybrid financial instruments and transfers, the OECD's recommendations may be summarized as follows:

- *Primary rule*: deny a deduction to the extent a payment is not taxed under the recipient's rules at ordinary rates

- *Secondary rule*: require that the recipient be taxed at ordinary rates with respect to payments which give rise to a deduction to the payer

Determining whether a financial instrument is characterized as debt or equity under the laws of various jurisdictions may be a challenging endeavor. From a U.S. tax perspective, the question of whether a financial instrument is properly characterized as debt or equity remains unsettled, and is based on a facts and circumstances analysis. Indeed, two financial instruments with identical terms may be considered debt in one case and equity in another from a U.S. perspective, depending on various factors such as the intent of the parties and the credit rating of the issuer. It is unclear how the OECD's proposals will address these uncertainties or how the rules will be administered going forward.

Hybrid Entity Payments

A hybrid entity payment mismatch results from differences in the treatment of an entity or arrangement between two jurisdictions. Hybrid entity payments can give rise to DD or D/NI outcomes. The discussion draft provides an example of a basic DD outcome technique and a basic D/NI outcome structure.

In the example illustrating a DD outcome, A Co (incorporated in Country A) holds all the shares of B Co (incorporated in Country B). B Co is a hybrid entity that is disregarded for Country A purposes and regarded as a taxable association for Country B purposes. B Co holds all of the shares of B Sub. B Co and B Sub file a consolidated tax return such that tax benefits from deductible payments from B Co may be surrendered to B Sub. Under this structure, B Co pays interest to a third party. Such interest is deductible to A Co since Country A considers B Co to be a branch of A Co. The interest is also deductible to B Sub, since it files a consolidated return with B Co.

With respect to hybrid entity payments generating DD outcomes, the OECD's recommendations may be summarized as follows:

- *Primary rule*: deny a deduction for the payment at the level of the owner of a hybrid entity to the extent it exceeds the "dual inclusion income" of the hybrid entity owner. "Dual inclusion income" is income that has been subject to tax in both the hybrid entity's taxing jurisdiction and the taxing jurisdiction of its owner.

- *Secondary rule*: deny a deduction in the hybrid entity's jurisdiction against income which is not dual inclusion income.

The United States currently has rules which are meant to avoid the DD outcome described above. In the U.S., this loss would be subject to the dual consolidated loss rules under section 1503(d).

Hybrid entity payments can also give rise to D/NI outcomes. The structure illustrated in the discussion draft is identical to the structure in the previous example where A Co owns hybrid entity B Co which in turn owns, and files on a consolidated basis with, B Sub. However, in this example, instead of interest being paid to a third party, interest is paid from B Co to A Co. The laws of Country A would disregard the payment from B Co to A Co and not tax it. On the other hand, Country B would allow a deduction.

With respect to hybrid entity payments resulting in D/NI outcomes, the OECD's recommendations may be summarized as follows:

- *Primary rule*: deny a deduction for the payment at the level of the owner of a hybrid entity to the extent it exceeds the dual inclusion income of the hybrid entity owner.

- *Secondary rule*: require that the recipient recognize income to the extent that the disregarded payment generates deductions in excess of the hybrid entity jurisdiction's consolidated dual inclusion income earned.

The mismatch resulting from the different tax treatment of certain business entities under the laws of various jurisdictions is not dissimilar to other differences between jurisdictions in calculating the tax base for ordinary income. For example, under the laws of certain jurisdictions, capital gains are included in the definition of taxable income, where in other jurisdictions such gains are exempt from taxation. Similarly, gains and losses from foreign currency transactions are factored into the tax base of a company in certain jurisdictions, but are ignored in others. Other examples of base differences include the treatment of pension payments, certain local income or excise taxes, charitable contributions, meals, travel and entertainment expenses, and other SG&A expenses. It may be questionable whether the difference in calculating tax base for ordinary income based on entity classification should be treated differently from other tax base differences between jurisdictions.

In addition, it is not clear how the OECD would treat contractual arrangements which may rise to the level of an entity in one jurisdiction but not in another. It is also unclear how investment vehicles such as trusts or partnerships will be affected. The discussion draft, however, takes a very broad approach to including all "hybrid" entities within the scope of its proposal, which may yield unintended or unanticipated results.

Reverse Hybrids and Imported Mismatches

An imported mismatch arrangement is either an entity hybrid or financing hybrid structure created under the laws of two jurisdictions where the tax mismatch is "imported" into a third jurisdiction.

The basic example of an imported mismatch arrangement based on an entity hybrid structure includes the use of a reverse hybrid entity. While hybrid entity mismatches address situations where payments made by a hybrid entity create DD or D/NI outcomes, this section of the discussion draft deals with mismatches in tax outcomes that can arise out of payments made to (reverse) hybrid entities. Reverse hybrid entities are transparent under the laws of the jurisdiction in which the reverse hybrid is established, and regarded under the laws of the owner of the reverse hybrid. Payments to reverse hybrid entities can result in D/NI outcomes when a deductible payment is received by a reverse hybrid and neither the reverse hybrid's taxing jurisdiction nor its owner's taxing jurisdictions impose tax on the payment.

Imported mismatch structures from hybrid financial instruments are accomplished through the use of back-to-back financing arrangements where one of the financial instruments is a hybrid instrument. The example provided by the discussion draft includes A Co (a Country A entity) owning B Co (a Country B entity). B Co lends to Borrower Co (a Country C entity). The interest payments are deductible to Borrower Co and are income to B Co. B Co then makes a payment on a hybrid instrument that generates a deduction at B Co and an exemption at A Co. The result is an importation of a tax benefit into Country C.

With respect to imported mismatches and reverse hybrids, the OECD's recommendations may be summarized as follows:

- *Primary rule*: investor jurisdiction includes the income received by a reverse hybrid (for example, through CFC rules)

- *Secondary rule*: if the investor jurisdiction does not subject the income to tax, the intermediary company (for example, a reverse hybrid receiving a payment) should be taxed in its jurisdiction

- *Defensive rule*: deny a deduction in the payer jurisdiction to the extent the intermediary company does not tax the payment.

This proposal recommends changes that may have a significant impact on jurisdictions with CFC rules focused on preventing deferral with respect to passive income. Jurisdictions often do not include within the scope of their respective anti-deferral rules interest paid by a CFC that is allocated to active income .This proposal appears to require that both active and passive income earned by a reverse hybrid be subject to CFC rules. Such a proposal seems generally inconsistent with the policy associated with existing CFC rules in multiple jurisdictions.

Recommendations for Treaty Provisions

The discussion draft also proposes model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect of hybrid instruments and entities. These proposed changes to the OECD Model Tax Convention are meant to ensure that hybrid instruments and entities are not inappropriately used to obtain treaty benefits. Coordination rules will be applicable if more than one country seeks to apply these proposed rules to a transaction or structure. Reference is made to the work undertaken in BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances.

The discussion draft looks at the options available for relief of double taxation on dividends under the exemption method or credit method and includes a proposal for a new model treaty 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. This provision applies 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). This proposed treaty provision is consistent with the provision currently found in Article 1(6) of the U.S. model treaty. The provision is also similar to current U.S. law under section 894(c) of the Internal Revenue Code.

The draft raises concerns regarding the potential application of anti-discrimination provisions which currently exist in the OECD model treaty. The discussion draft provides arguments explaining why the OECD believes their proposals do not run afoul of these anti-discrimination provisions found in Article 24 of the model treaty.