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International Tax

# United States Tax Alert

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## OECD Releases the BEPS Project 2014 Deliverables


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On September 16, the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD) released the documents (the 2014 deliverables) that it had promised, in the 2013 Action Plan on Base Erosion and Profit Shifting, to produce this year. The 2014 deliverables represent seven of the 15 actions of the BEPS Project, a project undertaken by the 44 countries that are, or will soon be, members of the OECD or of the G20 group of countries.

Some of the 2014 deliverables provide draft recommendations, agreed to by negotiators for the 44 countries, to change domestic tax laws, treaties, and other measures so as to combat government concerns about tax base erosion and profit shifting (BEPS) in cases involving (among other things) "hybrid mismatch arrangements" and tax treaty abuse. Five of the seven documents were previously issued in draft form and the 2014 deliverables provide refinements to the recommendations in the earlier drafts; two of the seven documents are entirely new.

The purpose of this Alert is to provide the essence, in very summary form, of the 2014 deliverables. (For a discussion of the 2014 deliverables that 1) recommend changes to the OECD Transfer Pricing Guideslines; and 2) recommend the process by which taxpayers document for tax authorities the bases for their internal transfer prices, see our recent Transfer Pricing alerts.)

### I. Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements

This deliverable (referred to herein as the September Report, the Report, or Action 2) does two things: it recommends changes to countries' domestic tax laws (Part I); and recommends changes to the OECD Model Tax Convention and its Commentaries (Part II).

**A. Part I—Recommended changes to domestic laws**

The recommendations for changes to domestic laws in the September Report

retain the basic design recommended in the discussion draft on the same topic that was released in March (the Discussion Draft). (For coverage of that draft, see United States Alert dated April 4, 2014.) The following is a brief outline of the recommended laws, a discussion of differences between the September Report and the Discussion Draft, and a summary of some of the topics on which the negotiators have yet to reach consensus:

### 1. Basic framework

#### a. What is a hybrid mismatch arrangement?

Part I's proposed domestic legislation would apply in the case of hybrid mismatch arrangements, arrangements in which (1) there is a difference in the tax treatment of an entity or an instrument under the laws of two or more tax jurisdictions, such that a payment by or between parties to such an arrangement produces a mismatch in tax outcomes, and (2) the mismatch lowers the aggregate tax burden of the parties to the arrangement.

Action 2 identifies two basic types of mismatched tax outcomes: (1) a D/NI (abbreviation for "deduction / no inclusion") outcome is one in which the payment is deductible to the payer but is not included in ordinary income by the payee or a related investor in the payee (i.e., is not income taxable at the full marginal rate without the benefit of any relief applicable to particular categories of payments); (2) a DD (abbreviation for "double deduction") outcome is one in which the payment is deductible under the laws of more than one jurisdiction.

#### b. Types of hybrid mismatch arrangements

Action 2 identifies five general types of hybrid arrangements.

- Two can give rise to D/NI outcomes: (i) *hybrid financial instruments* (including hybrid transfers, such as sale and repurchase agreements, or repos), where, for example, the payer/issuer on the instrument treats its payment as deductible interest and the payee/holder treats the payment as a tax-exempt dividend; and (ii) payments to *reverse hybrid* entities, meaning that the payee is fiscally transparent in the jurisdiction in which it was established, but not in its investor's jurisdiction.

- Another type of hybrid arrangement, involving payments by *hybrid entities* (hybrid payments), can give rise to D/NI *or* DD outcomes depending on the identity of the payee; here the term "hybrid" generally means that the payer is fiscally transparent under the law of the jurisdiction of its parent or investor, but not in its own jurisdiction.

- Payments by *dual residents* represent a fourth type of hybrid arrangement, and can generate a DD outcome.

- Finally, by tacking a hybrid arrangement onto a non-hybrid arrangement (e.g., a party in one jurisdiction pays interest to a lender in another jurisdiction under a non-hybrid debt instrument, and the lender is itself the issuer of a hybrid instrument to yet another party in a third jurisdiction), the three parties can achieve an indirect D/NI outcome in what Action 2 calls an *imported mismatch arrangement,* in that the mismatch is "imported" into the first jurisdiction.

### c. Overview of recommended laws

The following table summarizes laws that Action 2 recommends countries enact. The September Report in some instances modifies the recommended scope of the application of these laws as compared to the scope recommendations in the March Discussion Draft (also indicated below for reference).

| Mismatch | Arrangement | Specific recommendations on improvements to domestic law | Recommended hybrid mismatch rule | Scope of hybrid mismatch rule | |
|---|---|---|---|---|---|
| | | | | Discussion Draft (superceded) | September Report |
| D/NI | Hybrid financial instrument (includes hybrid transfers) | Deny dividend exemption and proportionate limitation of WHT credits (without limitation as to scope) | Response: Absent tax policy of the deduction to preserve tax neutrality, deny payer deduction<br>Defensive rule: Include as ordinary income | Under consideration | Related parties & structured arrangements |
| | Disregarded payment made by a hybrid | | Response: Deny payer deduction<br>Defensive rule: Include as ordinary income | Related parties (incl. persons acting in concert) & structured arrangements | Control group & structured arrangements |
| | Payment made to a reverse hybrid | Improvements to offshore investment regime<br>Restrict tax transparency of intermediate entities where nonresident control group investors treat the entity as opaque | Deny payer deduction | Control group (incl. persons acting in concert) & anti-abuse | Control group & structured arrangements |
| DD | Deductible payment made by a hybrid | | Response: Deny parent deduction<br>Defensive rule: Deny payer deduction | Response: no limitation on scope<br><br>Defensive rule: related parties (incl. persons acting in concert) & structured arrangements | Primary: no limitation on scope<br><br>Defensive: control group & structured arrangements |
| | Deductible payment made by a dual resident | | Deny resident deduction | | No limitation |
| Indirect D/NI | Imported mismatch arrangements | | Deny payer deduction | Control group (incl. persons acting in concert) and anti-abuse | Control group & structured arrangements |

### d. Recommended treatment of hybrid financial instruments

The Report recommends that investor/payee jurisdictions which generally provide for a dividend exemption or other dividend tax relief treat those dividends that are deductible in the payer jurisdiction as ordinary income to the payee. This would generally reduce the incidence of D/NI outcomes. The Report also recommends a

limitation on credits for tax withheld at the source if the same withholding tax is eligible as a tax credit in two different jurisdictions. (The foreign tax credit benefit would be limited in proportion to the net taxable income of the taxpayer under the arrangement.)

After taking any laws conforming to the above recommendations into account, in cases where D/NI outcomes would *still* be produced by a payment on a hybrid instrument, the Report recommends that the payer jurisdiction respond by generally denying a deduction for the payment, if received by a related party (defined by reference to a 25% ownership threshold) or in connection with a structured arrangement. Exceptions would be provided for deductions under regimes where the tax policy of the deduction is to preserve tax neutrality for the payer and payee, including treating income to the payee as ordinary income (e.g., dividends from RICs and REITs). The Report also recommends a "defensive rule" to be applied by *payee* jurisdictions in cases where the payer jurisdiction does *not* apply the recommended response (or allows the deduction pursuant to the tax neutrality exception). In that case, the payee jurisdiction would require the payment to be included in ordinary income.

#### e. Recommended treatment of payments by hybrid entities (hybrid payments) and dual residents

A disregarded payment by a hybrid entity (e.g., a payment to a U.S. parent company by its wholly-owned foreign subsidiary that is a disregarded entity for U.S. tax purposes under Reg. § 301.7701-3 but that is a taxable company under the law of its residence country) can generate a D/NI outcome if it can be deducted (e.g., via surrender or fiscal unity) by another foreign company that is not fiscally transparent under U.S. law—i.e., deducted against income that is not also included in the ordinary income of the payee/parent of the payer (Action 2 calls income that is so included "dual inclusion income"). The Report recommends that the payer jurisdiction respond to such a D/NI outcome by denying the deduction for the payment, assuming both payer and payee are members of the same controlled group or parties to a structured arrangement. The Report recommends as the defensive rule, to be applied in cases where the payer jurisdiction does not apply the recommended response, that the receipt of the payment be regarded as the receipt of ordinary income in the payee jurisdiction.

If the payment in the above example were to a third party rather than to the parent of the hybrid entity making the payment, it could, absent the rules recommended in Action 2, potentially generate a DD outcome: a deduction in the payer jurisdiction against income that is not dual inclusion income, *and* a deduction in the tax jurisdiction of the parent of the payer entity against the parent's income. Similar to the U.S. dual consolidated loss ("DCL") rules (Internal Revenue Code section 1503(d)), the Report recommends in this case that the jurisdiction of the parent respond by denying the deduction. The Report recommends as a defensive rule, to be applied in cases where the parent jurisdiction does not apply the recommended response, that the payer jurisdiction deny the deduction. If the paying entity is instead a dual resident and the payment gives rise to a similar DD outcome, the Report recommends (again not dissimilar to the U.S. DCL rules) that each residence jurisdiction of the payer deny the payer's deduction.

Note that while the U.S. DCL regulations already address the above two DD outcomes, those regulations do not address the immediately preceding D/NI outcome. Interestingly, the preamble to the regulations in fact suggested that the regulation's drafters *would* have addressed this D/NI case, but for the limitation on

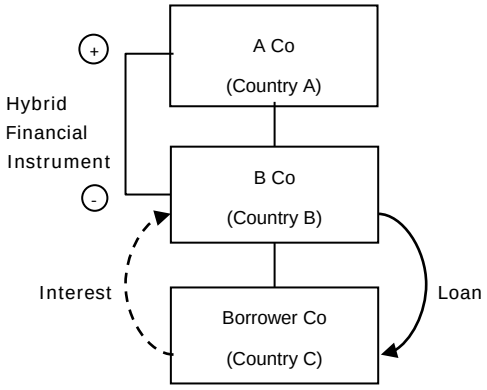
their regulatory authority.[1]

### f. Recommended treatment of payments to reverse hybrids

The Report recommends that the payer jurisdiction deny the deduction for a payment to a reverse hybrid to the extent it gives rise to a D/NI outcome and payer and payee belong to the same controlled group or are acting pursuant to a structured transaction. The Report also recommends changes to controlled foreign company (CFC) or other offshore investment regimes to prevent the possibility of D/NI outcomes when payments are received by reverse hybrid entities. The Report further recommends that D/NI outcomes be eliminated by adopting laws under which a jurisdiction would treat an entity established therein, and which is generally treated in that jurisdiction as fiscally transparent, as instead *not* fiscally transparent to the extent its income would otherwise escape taxation in both that jurisdiction and in that of a non-resident investor in the entity that is a member of the same control group as the entity.

### g. Recommended treatment of payments in imported mismatch arrangements

The Report states that an indirect D/NI outcome can occur when "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 such as an ordinary loan." For example, this type of D/NI outcome can occur as a result of the following structure:




In the above structure, Country A treats the hybrid financial instrument as equity and Country B treats the instrument as debt. Furthermore, Country A does not include payments on the instrument in taxable income but B Co claims a deduction for the payments. B Co then makes a loan to Borrower Co, which makes interest payments to B Co. Borrower Co claims a deduction for the interest payments under the laws of Country C and B Co pays no tax on the interest income because the income is offset by the deduction it receives on the payments under the hybrid instrument. Accordingly, an indirect D/NI outcome is achieved, as the benefit of the hybrid mismatch between Country A and Country B is imported to Country C using

[1]Preamble to T.D. 9315 (3/16/2007).

an ordinary loan.

The Report recommends that the payer jurisdiction (in the above case, Country C) deny the deduction for the payment to the extent the payment is offset in the payee's jurisdiction because of a hybrid mismatch arrangement, and the parties are in the same control group or the payment is part of a structured transaction.

### 2. Changes from the discussion draft

#### a. Definition of Related Person

In defining whether two persons are related, the Report increases the investment threshold from 10% to 25%.

#### b. Definition of Acting Together

In determining when to aggregate interests for purposes of determining whether two persons are related persons, both the Discussion Draft and the September Report treat persons acting together (or acting in concert) with respect to voting rights or equity interests as if they own the interests owned by the other. However, the Report provides that in the case of a taxpayer that is a collective investment vehicle, when the ownership of interests by two funds are managed by the same person or group of persons, then the interests held by those funds should not be aggregated by reason of such management, if the investment manager can establish to the satisfaction of the tax authority that the two funds were not acting together with respect to the investment.

#### c. Definition of Control Group

The Discussion Draft provided that a control group should mean "50% or more commonality of ownership including persons acting in concert." In addition, the Discussion Draft stated that the definition of a control group should include entities that are consolidated for financial accounting purposes.

The September Report modifies this definition. Specifically, the Report drops the "including persons acting in concert" language from the Discussion Draft, and adds the following additional ways for two persons to be treated as part of a control group: (1) one person has an investment that provides effective control of the second person, or a third person has effective control over both persons; or (2) the two persons can be regarded as associated enterprises under Article 9 (presumably of the OECD Model Tax Convention).

#### d. Policy-based exceptions from deduction disallowance at the payer level

As indicated above, the September Report recommendations stop short of recommending that payer jurisdictions disallow deductions for payments in cases where the deduction is designed to preserve tax neutrality (e.g., the dividends paid deduction for dividends paid by RICs and REITs). This exception was not in the Discussion Draft.

### 3. Issues still to be resolved

The OECD and G20 will provide written guidance on the application of the recommendations in the form of a Commentary to be published no later than

September 2015. In addition, the negotiators have yet to reach consensus on certain concerns raised by countries and businesses, including:

- The application of the hybrid instrument rule to transactions such as:
  - Intragroup hybrid regulatory capital
  - Certain on-market stock lending transactions
  - Sale and repurchase agreements

- The application of the hybrid mismatch rule to non-structured transactions, such as treasury center operations

- Whether income subject to taxation in an investor's jurisdiction (e.g., under a CFC regime) should be treated as included in ordinary income

- The extent to which the implementation of domestic law changes should be coordinated across jurisdictions, especially for non-controlled entities

- Transitional rules establishing how the rules will apply where the dates of implementation differ among countries

**B. Part II—Recommended changes to the OECD Model Tax Convention**

The recommended changes to the OECD Model Tax Convention and Commentaries, and other treaty material included in the Report, are very similar to those included in the discussion draft of treaty issues that was released March 19. The item of greatest significance in this regard in Part II of Action 2 is the addition of a "fiscally transparent entity" provision to Article 1 (Persons Covered) that is similar in purpose to Article 1(6) of the U.S. Model Income Tax Convention.

## II. Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Action 6 proposes changes to the OECD Model Tax Convention to prevent treaty shopping. In contrast to one possible outcome suggested in the discussion draft of Action 6 released in March, the September version does *not* recommend incorporating *both* a U.S.-style Limitation on Benefits (LOB) Article *and* a general anti-abuse rule (referred to here as the principal purpose test or PPT) of the type commonly appearing in non-U.S. treaties. Instead, the 2014 Deliverable agrees that a disjunctive approach is sufficient, allowing the Contracting States to choose *either* an LOB rule, supplemented by anti-conduit rules, *or* a PPT rule. "At a minimum," Action 6 reads,

- Countries should agree to include in their tax treaties an express statement "that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements"; *and*

- They should also implement that common intention through either:

  - the "combined approach," of *both* the LOB rule and the PPT rule, *or*

- the inclusion of the PPT rule, *or*
- the inclusion of the LOB rule supplemented by a mechanism—whether in the treaty or domestic rules, including judicial doctrines—that would deal with conduit arrangements not already dealt with in tax treaties.

This appears to be a compromise accommodating both sides of the LOB vs. PPT debate among the 44 countries.

With some exceptions, the proposed LOB rule is generally based on the U.S. Model Income Tax Convention. Action 6 proposes that the Commentary on the LOB rule be substantially similar to the Technical Explanation of the LOB Article of the U.S. Model.

Differences from the U.S. Model include the addition of a derivative benefits provision and a provision for collective investment vehicles (CIVs). Both the derivative benefits and CIV provisions are bracketed in the Report, as they are still under consideration. The status of the CIV provision reflects the ongoing debate on whether and to what extent countries should provide treaty benefits to CIVs and non-CIV funds.

With respect to the derivative benefits provision, we infer that the negotiators may be concerned about ways in which such a provision could create stateless income, and how it should be drafted to prevent that possibility.An indication of this appears in the ownership "prong" of the proposed derivative benefits test. It requires that in order to meet the test, generally 95% of a resident's shares must be owned, directly or indirectly, by seven or fewer equivalent beneficiaries. The proposed OECD Model language provides that indirect ownership is good ownership only if each intermediate owner is itself an equivalent beneficiary. This is not a requirement in any U.S. treaty now in force or awaiting ratification.[2]

> **Observation**: Under the OECD Model language proposed in Action 6, an equivalent beneficiary generally must be either (i) an individual, (ii) a government or wholly government-owned entity, (iii) a publicly traded entity, or (iv) a not-for-profit entity. The effect of requiring such equivalent-beneficiary status of an *intermediate* entity seems at first blush to negate the possibility that *indirect* ownership through *any* person (other than, perhaps, through a government-owned entity) could satisfy the proposed Model derivative benefits test; for it is hard to imagine how an individual, a publicly traded entity, or a not-for-profit entity could ever serve as the link in an ownership chain between seven or fewer ultimate owners of the type listed, on the one hand, and 95% of the shares of a single entity, on the other.

Other treaty anti-avoidance rules proposed in the March discussion draft of Action 6 are retained in the September version. These include rules to address: certain dividend transfer transactions; transactions that circumvent the application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property; dual resident entities; and situations where the state of residence exempts the income of permanent establishments

[2]The proposed 2013 protocol to the U.S.-Spain income tax treaty contains a derivative benefits clause with a rule that restricts the acceptable types of intermediate owners in cases of indirect ownership. However, the protocol's limitation provides that in the case of indirect ownership an intermediate owner need only be a resident of a member state of the European Union or a party to the North American Free Trade Agreement.

situated in a third state.

## III. Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

This deliverable, unlike those on Actions 1, 2, 6, is not a revision of a previously-released discussion draft of a BEPS Action Plan item. Rather, it is the first BEPS Project paper dealing with Action 5, a topic assigned by the Action Plan to the Forum on Harmful Tax Practices (FHTP), and with which the OECD and the FHTP have wrestled since the FHTP's creation in 1998: essentially, how to distinguish "good" tax incentives to encourage economic development from harmful tax regimes. In this respect, the Action Plan in 2013 drew a line by indicating that to be acceptable, any preferential regime must require substantial activity.

In general, this deliverable focuses exclusively on (1) measuring substantial activity when evaluating preferential tax treatment for certain income arising from qualifying intellectual property (e.g., a so-called IP box regime), and (2) developing a framework for compulsory spontaneous information exchange on taxpayer-specific rulings related to preferential regimes.

### A. Measuring substantial activities in connection with IP regimes

Action 5 discusses three approaches to measuring the substantiality of activity: (1) a value creation approach; (2) a transfer pricing approach; and (3) a nexus approach. Action 5 notes that each approach has its supporters and its critics among the countries in the FHTP, and devotes most of its attention to elaborating on the nexus approach to an IP regime where only patents and other IP assets that are "functionally equivalent to patents" can qualify for benefits.

The purpose of the nexus approach is to grant benefits only to income that arises from IP *where the actual research and development (R&D) activity was undertaken by the taxpayer itself.* The nexus approach allows an IP regime to provide benefits (e.g., a preferential rate on royalty income) *to the extent that* the income earned on the exploitation of that IP was generated by "qualifying expenditures." Qualifying expenditures are defined so as to effectively prevent mere capital contribution or expenditures for substantial R&D activity by parties *other than* the taxpayer from generally qualifying IP income for benefits under an IP regime.

Mathematically, the nexus approach determines the income that may receive the benefits of the IP regime by applying the following formula:

$$\frac{\text{Qualifying expenditures incurred to develop IP}}{\text{Overall expenditures incurred to develop IP}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

Taxpayers would be required to track expenditures and IP assets to ensure that the expenditures entering into the above fraction are expenses "directly connected to the IP asset." Taxpayers would be required to track the income generated from such IP assets (in the case of income from the sale of products, "embedded IP income") to ensure that the multiplicand is measured correctly.

> **Observation:** The formula makes it plain that a host of difficult measurement tasks could arise from the nexus approach. Difficulties may accumulate to the extent the taxpayer owns multiple IP assets and/or

earns income in multiple years subsequent to the expenditures, reflecting multiple factors in addition to the IP income to which the regime's benefits are designed to apply.

### B. Transparency of taxpayer-specific rulings related to preferential regimes

The Action Plan calls for the improvement of the transparency of preferential tax regimes, including the compulsory and spontaneous exchange of rulings related to preferential tax regimes. The Report discusses, but does not fully develop, a process for such exchanges.

## IV. Action 1: Addressing the Tax Challenges of the Digital Economy

Although the Action Plan originally instructed the Task Force on the Digital Economy (TFDE) to develop a framework of rules directly addressing BEPS risks in the digital economy, this deliverable (the Digital Report) instead recognizes the pervasiveness of the digital economy and concludes that attempts to "ring fence" it for special tax treatment is impossible.

The Digital Report indicates that BEPS risks exacerbated by the business models employed in the digital economy will be addressed primarily through other deliverables under the Action Plan. For example, the ability of multinational entities to avoid a taxable presence or otherwise limit tax in a market jurisdiction is not addressed through a separate recommendation developed by the TFDE, but may be addressed through Action 6, as discussed above, and yet-to-be developed Action 7 (Prevent the Artificial Avoidance of PE Status).

With most BEPS risks of the digital economy still to be addressed in other deliverables, the Digital Report itself discusses, without resolving, broader tax policy challenges. These tax policy challenges are separated into those concerning (1) taxable nexus created by the mobility of intangibles, users, and business functions; (2) attribution stemming from the collection and use of data; and (3) characterization of payments in certain digital economy business models.

Moving forward, the TFDE is to act as industry experts tasked with ensuring that the Action Plan deliverables adequately address BEPS risks of the digital economy. Consequently, much of the TFDE's job is left to be completed.

## V. Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Like the 2014 deliverable for Action 5, the 2014 deliverable for Action 15 is an initial public release of a BEPS Project paper. It covers "phase 1" of the issue of whether or how it would be feasible for 3,000+ tax treaties now in force to be revised to implement the BEPS Project recommendations through a multilateral instrument. The paper concludes that it would be feasible, in particular with respect to treaty recommendations in Actions 2 and 6 (as well as possible later treaty recommendations in future deliverables), to implement them through a single multilateral instrument. The instrument contemplated in the paper would allow adopting countries to "tailor their commitment" to a core set of provisions, to which countries can opt in or opt out. However, what that precisely means is unclear from the report. The report proposes that the G20 mandate an International Conference to further explore implementing a multilateral instrument in 2015.

## Conclusion

The BEPS Project remains a work in progress, and many of the most difficult questions have been deferred for later consideration. The 2014 deliverables provide a window into how the G20 and the member countries of the OECD may implement BEPS-related domestic tax law and treaty changes when the OECD's work is completed.

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