

BEPS Action 2: Hybrid mismatch arrangements

Introduction

The OECD released two Discussion Drafts on 19 March 2014 as part of its work on Base Erosion and Profit Shifting (BEPS) in relation to Action 2 (Hybrid Mismatch Arrangements) of the BEPS Action Plan. The proposals are split between: recommendations for domestic laws to neutralise hybrid mismatch arrangements; and recommendations for changes to the OECD Model Tax Convention to clarify the treatment of hybrid entities.

As with other Discussion Drafts on BEPS Actions, the proposals do not represent a consensus view from the G20/OECD countries involved but are designed to provide substantive proposals for public comment.

OECD proposal

The two key mismatch arrangements identified are payments deductible under the rules of the jurisdiction of the payer and not included in the income of the recipient, and payments that give rise to duplicate deductions.

Recommendations for domestic law

The Discussion Draft identifies the following design principles for the proposals:

- a. eliminate the mismatch without requiring the jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangements;
- b. be comprehensive;
- c. apply automatically;
- d. avoid double taxation through rule co-ordination;
- e. minimise disruption to existing domestic law;
- f. be clear and transparent;
- g. facilitate co-ordination with the counterparty jurisdiction while providing the flexibility necessary for the rule to be incorporated into the laws of each jurisdiction;
- h. be workable for taxpayers and keep compliance costs to a minimum; and
- i. be easy for tax authorities to administer.

The recommendations target three categories of hybrid mismatch arrangement:

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

The Discussion Draft recommends 'linking rules' within domestic legislation; a primary rule, to apply whenever a mismatch arises and, a secondary or defensive rule, to apply in circumstances where the primary rule does not

apply. This approach aims to neutralise the hybrid mismatch 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. Each linking rule has its own information requirements. The ability of tax authorities and taxpayers to obtain sufficient information to conclude whether a structure falls within the definition of a hybrid mismatch arrangement will vary depending on a number of different factors including whether the counterparty is a related or third party.

Two approaches are being considered in defining the scope of the rules: identify transactions which are of the most significant concern and specifically include them within the scope of the rules e.g. hybrid financial instruments held by related parties, or, define exceptions from a broad rule e.g. exclude widely held hybrid financial instruments.

Further changes to domestic law are recommended for hybrid financial instruments (restrict dividend exemptions for deductible payments and proportionate limitation of withholding tax credits) and for reverse hybrid and imported mismatches (intermediate jurisdiction tax filing and information requirements).

Banking and Insurance

The consultation document is explicit that the rules are intended to target only those instruments that are hybrids for tax purposes, and only seek to address the tax treatment of such arrangements. 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 hybrids for tax purposes. Thus, for example, third party debt raised by a bank or insurer on terms which enable it to be treated as capital for regulatory purposes but which is treated as debt for tax purposes for the borrower should not be impacted by the BEPS anti-hybrid proposals.

The position could however be different for intra-group financing arrangements, where securities which are treated as regulatory capital at a solo entity level could also be caught by the BEPS proposals. The UK Government has confirmed that it does not see a strong case for a full carve-out of banking and insurance hybrid capital instruments from the BEPS rules, as that might potentially give rise to an unfair advantage to banks and insurers. It has however indicated that it will consider whether special rules should apply when these instruments are a direct consequence of regulatory requirements.

Treaty issues

The Discussion Draft looks at the options available for relief of double taxation on dividends under the exemption method or credit method. The Discussion Draft 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, 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). Reference is made to the work undertaken in respect of BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances.

Timetable and Next Steps

The OECD has requested comments on the Discussion Drafts by 2 May 2014. A public consultation event will be held at the OECD in Paris on 15 May 2014 before finalisation at the G20 meeting on 20 and 21 September 2014.

Deloitte Comments and Issues

One of the challenges with hybrids has always been – which country is being disadvantaged? The OECD has

tackled this head-on with its view that a hybrid should be countered without asking the question at all.

The UK government issued a document on BEPS with Budget 2014, which stated its support for new international tax rules in this area. Changes may therefore be required to the current anti-arbitrage rules. It is important that the focus remains on designing a workable solution which is easy for tax authorities to administer and minimises taxpayer compliance costs.

The proposals are likely to impact many hybrid financing arrangements. Structures commonly used in financing to and from the US often involve UK companies subject to a 'check the box' election in the UK which causes interest paid to be disregarded. Consequently, financing arrangements such as the 'Tower' structure and similar strategies may need to be reviewed. Third party transactions are within the scope of some of the proposed rules, which is unhelpful, as there is a lack of information to the payer company about the tax treatment to recipients. Information requirements vary widely and are likely to prove burdensome in some cases.

Given that the changes are mainly effected through changing domestic law, it can be expected that once final proposals have been agreed in September, countries will start to legislate in 2015.

Forthcoming Deloitte EMEA Dbriefs Webcast

Deloitte's Dbriefs webcast programme for Europe, the Middle East and Africa will include a discussion of the Discussion Drafts on Hybrid Mismatch Arrangements on 16 April 2014 at 12.00pm (BST). For further details and to register for the webcast go to www.emeadbriefs.com.

Contacts

Bill Dodwell

Tel: 020 7007 0848

Email: bdodwell@deloitte.co.uk

Joanne Bentley

Tel: 020 7007 3646

Email: jcbentley@deloitte.co.uk

Joanne Pleasant

Tel: 020 7007 3409

Email: jmpleasant@deloitte.co.uk

David Hume

Tel: 020 7007 0859

Email: dahume@deloitte.co.uk

Tim Haden

Tel: 020 7007 3565

Email: thaden@deloitte.co.uk

Lisa Shipley

Tel: 020 7007 1343

Email: lshipley@deloitte.co.uk

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2014 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Member of Deloitte Touche Tohmatsu Limited