

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS:

BASE EROSION AND PROFIT SHIFTING (BEPS)



SUBJECT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) ISSUES FINAL REPORT ON ACTION ITEM 2: NEUTRALIZE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

SUMMARY

On October 5, 2015, the Organisation for Economic Co-operation and Development (OECD) issued the Final Report on Action Item 2: Neutralize the Effects of Hybrid Mismatch Arrangements (the "Report").

This alert is one installment in a series of alerts on the release of the OECD/G20 Base Erosion and Profit Shifting Project (the BEPS Project).

The OECD, a non-governmental forum established to promote economic growth, has developed a 15-point action plan to shape "fair, effective and efficient tax systems." The OECD's project regarding BEPS has addressed issues arising from tax planning strategies that exploit gaps or mismatches in member countries' tax rules.

BACKGROUND AND DETAILS

In an effort to address BEPS issues in a coordinated and comprehensive manner, the G20 finance ministers called on the OECD to develop an action plan to equip countries with instruments that will better align tax with economic activity. Action Item 2 aims to "neutralize the effects of hybrid mismatch arrangements."

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Specifically, the Report targets hybrid mismatch arrangements—arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. The Report notes that such arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned.

With a view toward increasing the coherence of corporate income taxation at the international level, the OECD/G20 BEPS Project called for recommendations regarding the design of domestic rules and the development of model treaty provisions that would neutralize the tax effects of hybrid mismatch arrangements. As a result, the Report provides recommendations to neutralize these arrangements---Part I of the Report addresses changes to domestic law, and Part II of the Report recommends changes relating to the OECD Model Tax Convention.

Specifically, Part I of the Report provides a recommendation for rules to address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. The recommendations take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise do not disturb the commercial outcomes. The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. This prevents more than one country applying the rule to the same arrangement and also avoids double taxation.

The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

The Report provides a common set of design principles and defined terms intended to ensure consistency in the application of the rules.

Part II of the Report addresses the part of Action item 2 aimed at ensuring that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I of the Report.

First, Part II examines the issue of dual-resident entities (i.e., entities that are residents of two States for tax purposes). It notes that the work on Action Item 6 (Preventing Treaty Abuse) will address some of the BEPS concerns related to the issue of dual resident entities by providing that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities. This change, however, will not address all BEPS concerns related to dual-resident entities; that is, domestic law changes will be needed to address other avoidance strategies involving dual residence.

The Report also deals with the application of tax treaties to hybrid entities (i.e., entities that are not treated as taxpayers by either or both States that have entered into a tax treaty, such as partnerships in many countries). The Report proposes to include in the OECD Model Tax Convention (OECD, 2010) a new provision and detailed Commentary that will ensure that benefits of tax treaties are granted in appropriate cases to the income of these entities but also that these benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.

Finally, Part II of the Report addresses potential treaty issues that could arise from the recommendations in Part I of the Report. It first examines treaty issues related to rules that would result in the denial of a deduction or would require the inclusion of a payment in ordinary income and concludes that tax treaties would generally not prevent the application of these rules. Next, the impact of the recommendations of Part I of the Report with respect to tax treaty rules related to the elimination of double taxation are examined and it is noted that problems could arise in the case of bilateral tax treaties that provide for the application of the exemption method with respect to dividends received from foreign companies. The Report describes possible treaty changes that would address these problems. The last issue dealt with in Part II of the Report is the possible impact of tax treaty rules concerning non-discrimination on the recommendations of Part I of the

Report; the Report concludes that, as long as the domestic rules that will be drafted to implement these recommendations are properly worded, there should be no conflict with these non-discrimination provisions.

The Report provides some guidance on asset transfer transactions (such as stock-lending and repo transactions), imported hybrid mismatches, and the treatment of a payment that is included as income under a controlled foreign company (CFC) regime. The consensus achieved on these issues is reflected in the Report.

BDO INSIGHTS

Multinational groups (especially U.S.-based multinational groups) frequently employ hybrid entities, hybrid instruments and/or dual resident companies in their organizational structure. The rules discussed in the Report above can have significant tax implications to the multinational group once a jurisdiction decides to implement such rules. Some countries have announced plans to restrict the use of hybrid entities or hybrid instruments. Consequently, multinational groups will need to monitor both domestic law and treaty developments to determine what the specific implications will be on their particular group. In some instances, multinational groups may need to consider some form of restructuring to avoid any negative impact the rules described above may have on their group.

It is worth noting that the United States currently has some rules addressing hybrid entities under domestic law (e.g., regulations under sections 894(c) and 1503(d)) and has incorporated rules addressing the use of hybrids in certain treaties (e.g., treaties containing articles similar to Article 1(6) of the 2006 Model Income Tax Convention). Additionally, there have been proposals by the Administration to specifically address the use of hybrid entities and “stateless income.”

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