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BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements 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. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

With a view to 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 neutralise the tax effects of hybrid mismatch arrangements. This report sets out those recommendations: Part I contains recommendations for changes to domestic law and Part II sets out recommended changes to the OECD Model Tax Convention. Once translated into domestic and treaty law, these recommendations will neutralise hybrid mismatches, by putting an end to multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid. By neutralising the mismatch in tax outcomes, the rules will prevent these arrangements from being used as a tool for BEPS without adversely impacting cross-border trade and investment.

This report supersedes the interim report *Neutralising the Effect of Hybrid Mismatch Arrangements* (OECD, 2014) that was released as part of the first set of BEPS deliverables in September 2014. Compared to that report, the recommendations in Part I have been supplemented with further guidance and practical examples to explain the operation of the rules in further detail. Further work has also been undertaken 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. As indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital. Where one country chooses not to apply the rules to neutralise a hybrid mismatch in respect of a particular hybrid regulatory capital instrument, this does not affect another country's policy choice of whether to apply the rules in respect of the particular instrument.

Part I

Part I of the report sets out recommendations 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 recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations. To this end, it sets out a common set of design principles and defined terms intended to ensure consistency in the application of the rules.

Part II

Part II addresses the part of Action 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.

Part II first 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 6 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, domestic law changes being needed to address other avoidance strategies involving dual residence.

Part II 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 addresses potential treaty issues that could arise from the recommendations in Part I. 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. It then examines the impact of the recommendations of Part I with respect to tax treaty rules related to the elimination of double taxation and notes 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 is the possible impact of tax treaty rules concerning non-discrimination on the recommendations of Part I; 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.

Sources

- *OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Reports, Executive Summaries*
- *2015 Final Report on Action 2*

MME observations

Action 2 includes a recommendation for the introduction of domestic hybrid mismatch rules to neutralise the effect of hybrid instruments and entities. Other recommended domestic provisions include the denial of a dividend exemption for tax deductible payments and measures to prevent hybrid transfers being used to duplicate withholding tax credits. Finally, there is a proposed change to the OECD model treaty to ensure hybrid entities are not used to obtain treaty benefits unduly. The hybrid mismatch rules operate automatically and contain a primary response and a defensive rule to avoid double taxation and to ensure that the mismatch is eliminated even where not all jurisdictions adopt the rules. It is noted that countries will be free to decide whether to apply the rules to mismatches in respect of intra-group hybrid regulatory capital instruments.

Companies with dividend paying subsidiaries or existing intra-group financing or IP arrangements will need to assess the impact if the recommended rules were to be introduced by a relevant jurisdiction.

Developments in Switzerland

Switzerland has already enacted domestic provisions with regard to the denial of a dividend exemption for tax deductible payments decades ago. No additional domestic hybrid mismatch rules are expected to be introduced.

Switzerland supports the change of Art. 1 II of the OECD model treaty which states that 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 since this is already common practice. However, Switzerland does currently not support the changes of Art. 1 III and 4 III of the OECD model treaty.

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