OECD Releases Discussion Drafts on Hybrid Mismatch Arrangements

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In July 2013, the Organisation for Economic Co-operation and Development (OECD) released its *Action Plan on Base Erosion and Profit Shifting* (the BEPS Action Plan). The BEPS Action Plan identified hybrid mismatch arrangements as a source of base erosion and profit shifting concern (Action 2). (For further details on the BEPS Action Plan see our Osler Update, July 19, 2013.)

On March 19, 2014, the OECD released two draft discussion papers that present proposals for neutralizing the effects of hybrid mismatch arrangements. The first makes recommendations for domestic law changes (First Discussion Draft). The second addresses OECD model treaty considerations (Second Discussion Draft). Comments on the discussion drafts are being accepted until May 2, 2014.

Domestic Law Recommendations

The First Discussion Draft defines a hybrid mismatch arrangement as one that "utilises 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 mismatching tax outcomes targeted by the report are the following:

- Deduction/No Inclusion (D/NI) outcomes in which payments are deductible under the rules of the payer's jurisdiction and not includible in income in the recipient's jurisdiction; and
- Double Deduction (DD) outcomes in which a single economic expenditure results in duplicated deductions in two taxing jurisdictions.

The First Discussion Draft identifies three categories of "hybrid mismatch arrangements" that are addressed by its domestic rule recommendations. Examples illustrating each of these categories are included in the First Discussion Draft.

(1) Hybrid financial instruments (including hybrid transfer arrangements)

Hybrid financial instruments (and certain hybrid transfer arrangements, such as certain cross-border repo or forward purchase arrangements) are a BEPS concern because they can produce a D/NI outcome. In order to address the D/NI result, the First Discussion Draft recommends the introduction of domestic rules in the context of hybrid financial instruments (including transfers) that

- as a "primary" rule, deny a deduction for the payment made under a hybrid financial instrument to the extent that the recipient does not include the amount as ordinary income;
- as a secondary, or "defensive" rule, require the payment to be included in income of the recipient if the payer is allowed a deduction in its home jurisdiction; and

- in the case of jurisdictions that provide a dividend exemption or deduction (for example, in respect of an exempt surplus dividend under Canadian law), provide that such exemption or deduction is not applicable to the extent the payment in question is deductible by the payer.

The scope of the proposed rules is being considered. The First Discussion Draft indicates that the OECD is considering both a "bottom-up" approach, which would identify and target specific transactions and arrangements causing the most concern, and a "top-down" approach, which would apply more broadly but provide targeted exceptions.

(2) Hybrid entity payments

Hybrid entity payments refer to payments made by an entity that is treated as a taxable entity by its "home" jurisdiction, but that is treated as fiscally transparent in the jurisdiction in which its investor resides. Hybrid entity payments can either result in a D/NI outcome, or in a DD outcome. The First Discussion Draft notes that hybrid entity payments only pose a BEPS concern where the deduction in one jurisdiction or the other is against income that is not subject to tax in both jurisdictions, referred to as "dual inclusion income." These structures often rely on the existence of tax consolidation regimes that permit a deduction by one member of the group to be used to reduce income generated by another group member.

For hybrid entity payments that result in a D/NI outcome, the First Discussion Draft recommends a primary rule that would limit the deductibility, in the hybrid entity's home jurisdiction, of hybrid payments that can be set off against non-dual inclusion income. A secondary or defensive rule would require an income inclusion in the investor jurisdiction. In the case of hybrid entity payments that result in a DD outcome, under the primary rule the investor jurisdiction would deny the deduction, and the home jurisdiction would deny the deduction as a secondary or defensive rule.

(3) Imported mismatches and reverse hybrids

The third category of hybrid mismatch arrangements identified in the First Discussion Draft is "imported mismatch arrangements." In general, these are arrangements in which the mismatch effects of hybrid structures (employing hybrid instruments or hybrid entities, as described in (1) and (2)) involving two jurisdictions are effectively imported into a third jurisdiction. One subset of imported mismatch arrangements that receives particular attention in the First Discussion Draft is "reverse hybrids."

As noted above, hybrid entity payments are made *by* a hybrid entity that is not fiscally transparent in its home jurisdiction but that is fiscally transparent in the investor jurisdiction. The First Discussion Draft also recognizes that inappropriate mismatches in tax outcomes can be engineered through payments *to* a hybrid entity. The First Discussion Draft notes that the hybrid recipient entity in these structures is usually a "reverse hybrid" that is fiscally transparent in its home jurisdiction but that is fiscally non-transparent in the investor jurisdiction.[1] As illustrated in the First Discussion Draft, reverse hybrid structures can give rise to D/NI outcomes if (a) the payment to the reverse hybrid is deductible in the payer's jurisdiction; (b) there is no tax imposed by the reverse hybrid's home jurisdiction (because that jurisdiction regards the reverse hybrid as fiscally transparent); and (c) the laws of the investor's jurisdiction do not treat the payment received by the reverse hybrid as current income of the investor.

In order to combat the mismatch effects of reverse hybrid structures, the First Discussion Draft recommends that investor jurisdictions implement specific and targeted controlled foreign corporation rules to tax income derived from reverse hybrid structures on a current basis (e.g., as FAPI under Canadian law). As a secondary rule, intermediary jurisdictions

should tax income earned by a fiscally transparent entity to the extent that the investor jurisdiction treats the entity as a reverse hybrid and does not tax the intermediary's income. As a defensive rule, the payer jurisdiction should deny a deduction where neither the intermediary nor the investor jurisdiction taxes the income. These rules would be buttressed by information reporting requirements in the intermediary jurisdiction.

Treaty Recommendations

The Second Discussion Draft recommends that hybrid arrangements involving dual resident entities be dealt with by a domestic law provision, similar to subsection 250(5) of Canada's *Income Tax Act*, that deems an entity not to be resident in a country under its domestic law where it is resident of a different country under an applicable tax treaty.

The Second Discussion Draft also proposes to add a new provision to Article 1 of the OECD Model Treaty that would address income of fiscally transparent entities. Specifically, income of an entity treated as fiscally transparent by either state would be treated as income of a resident of a state for treaty purposes only where it is treated as income of a resident of that state under that state's domestic tax law.

Conclusion

The recommendations in the First Discussion Draft represent sweeping measures that target widespread and common cross-border structures expressly designed to take advantage of hybrid arrangements. While Canada has addressed some of the issues identified in the Discussion Drafts – by addressing certain hybrid entity concerns in the Canada-U.S. Tax Treaty and by implementing foreign tax credit generator rules – Canadian taxpayers continue to benefit from cross-border structures that employ hybrid elements described in the First Discussion Draft. From a Canadian perspective, the adoption of some or all of these measures would represent a significant overhaul of Canada's domestic law, in particular the foreign affiliate regime and the interest deductibility rules. Changes to the domestic laws of many other OECD countries, including the United States, would be similarly dramatic. Crafting rules that are appropriately scoped and linked to the tax treatment afforded a particular payment in another country appears to be a daunting task. The First Discussion Draft identifies, but does not resolve, many of the complex tax policy and technical issues associated with the proposals.

Nevertheless, in making its proposals, the OECD is sending a strong signal that many governments are prepared to take bold and innovative steps to combat tax reduction and profit-shifting techniques that take advantage of hybrid arrangements, even if such techniques are currently in full compliance with relevant domestic law of each of the jurisdictions involved. Taxpayers that employ such structures need to carefully monitor developments in this area, and to ensure that they are prepared to react to any domestic legislative (or treaty-based) changes that may impact them.

For further information or for advice on how these proposals may affect you, please contact any member of Osler's national tax group.

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[1] Interestingly, there is a mismatch between the meaning ascribed to the term "reverse hybrid" in the OECD's First Discussion Draft and the meaning customarily given to the term "reverse hybrid" for U.S. federal income tax purposes. For example, United States Treasury Regulation 1.894-1(d)(2) defines a "domestic reverse hybrid entity" as a U.S. entity that is

treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction.