CLIFFORD CHANCE

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BEPS Action 2 – Hybrids: OECD final proposals and their potentially wide impact on cross-border dealings

As part of the OECD's Base Erosion and Profit Shifting ("BEPS") project, final proposals have been published to address cross-border hybrid arrangements that give rise to tax outcomes that are not consistent between jurisdictions.

Following on from our September 2014 client briefing on the OECD's initial recommendations to address that tax "mismatch", we provide an update on the final proposals and look at their potential impact on cross-border business and where we head now on the taxation of hybrid arrangements.

What is the focus?

The OECD is concerned about "hybrid mismatch arrangements" - cross-border arrangements where the tax treatment in one jurisdiction is not consistent with the tax jurisdiction in other jurisdictions. The aim of the OECD's final proposals is to eliminate those differences by using the tax characteristics of hybrid arrangements in a particular jurisdiction to determine the corresponding tax treatment.

Examples of hybrid mismatch

The OECD is looking to address the following tax outcomes arising from hybrid mismatches:

- A deduction in one jurisdiction with no corresponding increase in the taxable income in another jurisdiction;
- A deduction in multiple jurisdictions for the same expense ("Double Deduction"); and
- Accessing tax credits in multiple jurisdictions for the same expense ("Double Tax Credit").

What are hybrid arrangements

Hybrid arrangements fall into three broad categories:

- **hybrid financial instruments**, where the instrument is treated as debt in one jurisdiction and equity in another jurisdiction;
- **hybrid transfers**, where there is an asset transfer (e.g. a repo) that is treated by its form in one jurisdiction (e.g. as an asset sale) and by its economic substance in another jurisdiction (e.g. as a collateralised loan); and
- **hybrid entities**, where an entity is treated as a taxable entity in one jurisdiction, but tax transparent in another jurisdiction (e.g. US "check the box" entities).

Key issues

- The rules have potentially wide impact on a range of cross-border dealings
- No "grandfathering" of existing arrangements
- Underlying principle is to align tax characteristics in each jurisdiction – tax treatment in a jurisdiction will be based on tax treatment in "home" jurisdiction
- Proposals have both normal and defensive components, allowing jurisdictions unilaterally to address the issue without global co-operation
- Jurisdictions are open to exclude, or make alternative arrangements, for regulatory capital
- Should not apply to issuance of corporate hybrid bonds to third party investors

Summary of OECD proposals for domestic laws

Tax mismatch	Primary rule	Defensive rule	Applies to:
Deduction in one jurisdiction without taxable income in other jurisdiction	Deny deduction to payer	Include amount as ordinary income of payee	Related parties, groups and structured arrangements
Double Deduction	Deny deduction to parent (except where dual resident, deny deduction to payer)	Deny deduction to payer	Primary rule applies in all circumstances; Defensive rule limited to groups and structured arrangements.
Double Tax Credit	Limit tax credit to net taxable income from hybrid arrangement	N/A	Whenever a double tax credit arises

The proposals are also designed to capture "indirect" or "imported" hybrid arrangements, so that chains of financial instruments/structures cannot be used to shelter from hybrid rules.

When are the proposed rules designed to apply?

As summarised in the table above, the rules are proposed to usually apply only where the parties are in a group, are related parties or are parties to a structured arrangement, as follows:

- A group will arise where there is at least 50% investment by one party in the other, or by a third party in both, or the entities are under common control.
- A related party is where there is a 25% investment by one party in the other, or by a third party in bother entities.
- A structured arrangement is where the hybrid mismatch is priced into the terms of the arrangement, or it has been designed to produce a hybrid mismatch. However, a taxpayer won't be a party to a structured arrangement if that taxpayer and its group could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the tax benefit.

For hybrid financial instruments or hybrid transfers, the mismatch also needs to be caused by the nature of the hybrid arrangement (rather than, for example, a broader tax policy decision such as a jurisdiction exempting pension funds from taxation).

However, there is no requirement for a tax avoidance purpose or motive. This raises the spectre of genuine commercial arrangements and structures falling within the proposed rules.

There are also no proposals for grandfathering – whilst there may be transitional regimes, existing arrangements will likely fall within the proposals (if implemented).

Regulatory capital

The OECD has not adopted a specific proposal to deal with regulatory capital, and has instead left it to individual jurisdictions to deal with. This may be a positive move, as it allows jurisdictions with major financial centres the ability to structure the rules appropriately. It is likely that most jurisdictions will probably exclude regulatory capital from the hybrid rules. However, as each jurisdiction adopts their own approach, there may be added complexity in structuring regulatory capital for investors.

Interaction with CFC rules

The OECD has recommended that where hybrid mismatch arrangements are captured under CFC rules, that the hybrid rules would not apply subject to the relevant investor demonstrating to the tax authorities that the hybrid payment has been fully taxed.

The OECD also recommends CFC rule changes to deal with reverse hybrids.

What do the rules do?

The proposed rules are designed so that the tax treatment in one jurisdiction is mirrored in the other jurisdiction(s).

The table above summarises the relevant application of the rules. The primary rule is designed to primarily impact on the jurisdiction of the payer of the amount (or the parent entity in Double Deduction situations). The defensive rule is designed to operate where the jurisdiction of the payer doesn't adopt the primary rule.

Who is likely to be affected?

The proposals apply in very broad circumstances, particularly in relation to hybrid financial instruments between related parties, which is a very low threshold.

However, there will be particular impact on:

- **Multinational groups**, which routinely deal with different jurisdictions, and particularly groups with a US presence, as US "check the box" rules mean that there are frequently hybrid entities;
- **Groups with IP holding structures or group treasury/financing structures**, which make use of Dutch CV/BV structures and Luxembourg SCS/Sarl structures;
- **Capital market and structured debt issuers**, where investors may treat the investment as equity but the issuer treats it as debt (such as subordinated debt with US investors);
- **Participants in the repo market**, as the proposed hybrid rules are specifically designed to capture these types of transactions by treating repos as financial instruments, and there are often variances in how the transactions are treated in each jurisdiction giving rise to hybrid mismatches;
- **Funds**, as hybrid financial instruments and hybrid entities are often used to cater for a wide variety of investors out of a single fund. Whilst there may be some relief for funds in respect of the rules affecting hybrid entities, in that it will be rare for a single investor/group to have more than 25% investment in the fund, on the downside the proposals (if implemented) will require funds to have a much better appreciation of the tax characteristics of their investors.

Other proposals

The OECD has also proposed a number of specific target measures to deal with hybrid arrangements:

- Denying the dividend exemption on distributions that are deductible to the issuer;
- Improving or introducing CFC rules to deal with reverse hybrid structures;
- For reverse hybrid entities, limiting the tax transparency of the entity for non-resident investors where those investors are not taxed in their home jurisdiction;
- Improved reporting obligations on entities and intermediaries to determine how hybrid entities are treated; and
- Amendments to the model double tax treaty so that benefits are denied to entities that are treated as transparent under the laws of either state.

What about corporate hybrids?

There has been speculation that the BEPS proposals would affect corporate hybrid capital instruments – bonds issued by corporates to third party investors which are treated as debt for tax purposes, but have some equity-like features (and may, for example, be treated as equity for accounting purposes).

However the final proposals have retained the related party/structured arrangement condition outlined above; and so it is likely the great majority of corporate hybrid capital instruments in the market will not be affected by these proposals.

Of course hybrids of this type may be affected by other tax changes, for example BEPS Action 4 on interest deductibility, or the changes to the UK loan relationship rules in the Summer 2015 Finance Bill.

What next?

It is important to note that the OECD proposals need to be adopted into domestic law before they apply.

This means that there will likely be a piecemeal adoption by various countries over different timeframes, and some countries that are unlikely to take any action at all (for example, the US are unlikely to adopt these proposals), and there may be significant resistance in other financial centres (or states looking to grow as financial centres)

For EU jurisdictions which may want to resort to defensive rules due to the lack of action in other key jurisdictions, there is a risk of a challenge under EU law where there is not consistency across the EU.

All of this raises significant uncertainties for cross-border dealings, particularly in trying to establish the ongoing commercial viability of a variety of transactions and structures.

What to do?

At this stage, until we see actual legislative proposals or other responses from jurisdictions, we recommend:

- closely monitoring implementation in jurisdictions;
- reviewing existing arrangements and identifying risk areas; and
- bearing in mind the proposals (and the uncertainty) in putting together new cross-border deals.

As the proposals need to be implemented domestically, there also remain opportunities to work with local jurisdictions to demonstrate how the proposals might impact on arrangements that could be caught by the hybrid proposals but which represent normal commercial dealings and are not tax-driven. This will be particularly the case in key financial centres, where the proposals may impact on efforts to retain and grow finance-related businesses.

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