Hybrid mismatch briefing
Base Erosion Profit Shifting (BEPS) Action 2

Tax landscape

- More transparency
- Fair contribution
- Tax being utilised as a behavioural tool along with regulatory change
- Tax and regulatory regimes moving closer together

Cause

Companies such as GE, Apple, Starbucks, Amazon and Google either avoiding or significantly reducing their liability to tax in one jurisdiction in favour of another low tax or no tax jurisdiction.

BEPS Action Plan

- *The digital economy* – how to deal with the source of income, residence of a party to a transaction and the income character for tax purposes
- *Transparency* – cross-jurisdiction government cooperation, more disclosure, purpose of the trade and is it tax motivated, substance.

The Actions themselves

- In total, there are 15 with different time frames for completion. ISLA sub-group tax is concerned by Action 2 Neutralising Hybrid Mismatch and Action 6 Prevent Treaty Abuse, both of these Actions have a September 2014 completion date for the OECD recommendations. Jurisdictional implementation of the recommendations possibly 2015 or 2016.

What is a hybrid mismatch?

Hybrid financial instruments – D/NI where a tax deductible payment (D) may not be taxable income in the hands of payee (NI). This could be the case for payments made under Stock loan or repo arrangement.

Stock loan/borrow example – (D) Borrower obtains a deduction for a payment to lender Under the arrangement. (NI) lender is not taxable on the manufactured dividend income through the use of tax credits for example.

Hybrid mismatch – The arrangement produces D/NI. Deduction may therefore be denied. Should borrower jurisdiction not deny the deduction then lender may have to treat the income as taxable.

Repo example – (D) premiums paid under the repo treated as tax deductible. (NI) purchase price is an exempt receipt with the sale of the asset treated as a tax exempt gain.

Hybrid mismatch – The arrangement produces D/NI this could include as well a dividend Income exemption. Possible restrictions for tax credit relief. Deduction may therefore be denied.

Hybrid Transfer – In both cases, the parties to the trade resident in different jurisdictions are both treated as the owner of the same asset under the laws of their own jurisdiction.

Hybrid entity payments – where differences in the characterisation of the hybrid payer result in a deductible payment being disregarded or triggering a second taxable deduction in the other jurisdiction (DD)

Reverse hybrid and imported mismatches – e.g., payments made to an intermediary which are not taxable upon receipt caused by a characterisation issue for example which may result in a payment being disregarded in both the intermediary and client/counterparty jurisdictions as well as an intermediary involvement in a non-connected mismatch arrangement causing a set-off against a taxable deduction.

Open matters

- Top down or a bottom up approach
- Related parties
- All structured arrangements should be in scope
- Carve-out for widely held or traded instruments

Design principles

- Comprehensive
- Apply automatically
- Tie breaker rule
- Cross-jurisdiction cooperation

Treaty abuse – prposals BEPS Action 6

- Treaty based LoB test
- Main Purpose test
- More targeted anti- avoidance rules around dividend re-characterisation or dividend transfers
- Carve out for Collective Investment Funds