

Public Discussion Draft

**BEPS ACTION 2:
NEUTRALISE THE
EFFECTS OF HYBRID
MISMATCH
ARRANGEMENTS**

(Recommendations for
Domestic Laws)

19 March 2014 – 2 May 2014



Comments on this note should be sent electronically (in Word format) by email to aggressivetaxplanning@oecd.org before 5.00pm on 2 May 2014 at the latest.

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This document does not necessarily reflect consensus views of either the Committee of Fiscal Affairs or of WP11 regarding the issues it addresses. Rather it reflects preliminary consideration of the issues since the publication of the Action Plan and seeks to identify issues for public comment. It is considered that stakeholder comments are essential to advancing this work.

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NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

RECOMMENDATIONS FOR DOMESTIC LAW

BACKGROUND AND INTRODUCTION

1. Background

1. The role played by hybrid mismatch arrangements in aggressive tax planning has been discussed in a number of OECD reports. For example, an OECD report on *Addressing Tax Risks Involving Bank Losses* (OECD, 2010) highlighted their use in the context of international banking and recommended that revenue bodies “bring to the attention of their government tax policy officials those situations which may potentially raise policy issues, and, in particular, those where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity”. Similarly the OECD report on *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD, 2011) recommended countries “consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results”.

A. *Hybrids Report*

2. As a result of concerns raised by a number of OECD member countries, the OECD undertook a review with a number of interested member countries to identify examples of tax planning schemes involving hybrid mismatch arrangements and to assess the effectiveness of response strategies adopted by those countries. That review culminated in a report, on *Hybrid Mismatch Arrangements* in 2012 (the Hybrids Report).¹ The Hybrids Report concludes that the collective tax base of countries is put at risk through the operation of hybrid mismatch arrangements even though it is often difficult to determine unequivocally which individual country has lost tax revenue under the arrangement. Apart from impacting on tax revenues, the report also concluded that hybrid mismatch arrangements have a negative impact on competition, efficiency, transparency and fairness. The Hybrids Report sets out a number of policy options to address hybrid mismatch arrangements:

(a) *Harmonisation of domestic laws*

3. The Hybrids Report did not consider that harmonisation was an option for eliminating hybrid mismatches as it did not seem possible for countries to agree on harmonised treatment even for the most commonly exploited differences in tax treatment among different countries.

¹ OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*.

(b) *General anti-avoidance rules*

4. The report noted that general anti-avoidance rules (including judicial doctrines such as “abuse of law”, “economic substance”, “fiscal nullity”, “business purpose” or “step transactions”) could be an effective tool in addressing some hybrid mismatch arrangements, particularly those with circular flows, contrivance or other artificial features, however the terms of general anti-avoidance rules and the frequent need to show a direct link between the transactions and the avoidance of that particular jurisdiction’s tax tended to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements. As a consequence, although general anti-avoidance rules are an effective tool, they do not always provide a comprehensive response to cases of unintended double non-taxation through the use of hybrid mismatch arrangements.

(c) *Specific anti-avoidance rules*

5. The report noted that a number of countries have introduced specific anti-avoidance rules that had an indirect impact on hybrid mismatch arrangements. For example, certain countries have introduced rules that in certain cases deny the deduction of payments where they are not subject to a minimum level of taxation in the country of the recipient. Similarly, other countries deny companies a deduction for a finance expense where the main purpose of the arrangement is gaining a tax advantage under local law. While these provisions are not specifically aimed at deductions with no corresponding inclusion for tax purposes, they may impact on those structures by denying the deduction at the level of the payer.

(d) *Rules specifically addressing hybrid mismatch arrangements*

6. Finally the report considered rules which specifically targeted hybrid mismatch arrangements. Under these rules, the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in the foreign country, thus eliminating the possibility for mismatches. The report concluded that domestic law rules which link the tax treatment of an entity, instrument or transfer to the tax treatment in another country had significant potential as a tool to address hybrid mismatch arrangements. Although such “linking rules” make the application of domestic law more complicated, the report noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses, and controlled foreign company rules often do exactly that.

B. *BEPS Action Plan*

7. The OECD Committee of Fiscal Affairs (CFA) approved the BEPS Action Plan² at their meeting on 25 June 2013. The Action Plan was subsequently endorsed at the meeting of the G20 Heads of Government in Saint Petersburg on 5-6 September 2013.

8. Action 2 of the Plan calls for the development of “model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities.” Action 2 states that “this may include:

- (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;
- (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor;

² OECD (2012), *Action Plan on Base Erosion and Profit Shifting*

- (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);
- (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
- (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.”

9. At their June 2013 meeting, the CFA also mandated the formation of Working Party No. 11 on Aggressive Tax Planning (WP11) to assist the CFA with its responsibilities in relation various items in the Action Plan and, in particular, to develop the instruments called for in Action 2.

2. Hybrid Mismatch Arrangements and the OECD Model Convention

10. The 1999 OECD report *The Application of the OECD Model Tax Convention to Partnerships*³ (the Partnership Report) contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The Partnership Report, however, did not consider the application of the tax transparency rules to entities other than partnerships (i.e. hybrid entities that do not constitute partnerships under the law of the contracting jurisdictions but are nevertheless treated as fiscally transparent for tax purposes) and did not consider payments made under hybrid financial instruments.

11. Working Party No. 1 on Tax Conventions and Related Questions (WP1) is currently considering a number of possible amendments to the OECD Model Convention that would further develop the analysis set out in the Partnership Report. This includes a treaty rule under which income derived by or through an entity or arrangement that is treated as fiscally transparent under the laws of one of the treaty countries shall be considered to be income of a resident of a contracting state only to the extent that the income is treated, for purposes of taxation by that jurisdiction, as the income of a resident of that jurisdiction.

12. Action 2 also calls for special attention to be given to the interaction between the domestic rules and the OECD Model Convention. The potential for conflict between domestic hybrid mismatch rules and the outcomes provided for under the OECD Model Convention depends, to a significant extent, on the manner in which the domestic rules go about neutralising the tax consequences under the arrangement. Hybrid mismatch solutions that focus on denial of deductions in the payer state and/or forcing the inclusion in the payee state are domestic law solutions imposed on domestic taxpayers and, at first glance, would not appear to implicate the taxing rights of other states. The provisions of the OECD Model Convention may be implicated, however, if a hybrid mismatch solution involves the imposition of tax on a non-resident with no permanent establishment in the taxing state. Further there may be concerns about the potential application of anti-discrimination provisions in the OECD Model Convention.

13. The interaction between the recommendations set out in this Consultation Document and the OECD Model Convention are currently being considered by WP1, together with further recommendations for amendments to the OECD Model Convention that would address those situations where hybrid mismatch arrangements also involve issues of treaty abuse. WP1’s work on these questions will form part of the final report that will incorporate both model treaty provisions and recommendations regarding the design of hybrid mismatch rules.

³ Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(15)-1. Hereafter the “Partnership Report”).

3. Work Undertaken in the Context of the European Union

A. *Work on hybrid financial instruments*

14. In a 2010 report to the ECOFIN Council⁴ the European Union (EU) Code of Conduct Group (Business Taxation) agreed that participation exemptions should not exempt payments that were treated as tax deductible by the country of the payer. The European Commission has published a proposal to amend the European Parent – Subsidiary directive so that it would not apply to a profit distribution that was deductible by the subsidiary.⁵

B. *Work on hybrid entities*

15. A Subgroup of the EU Code of Conduct Group (Business Taxation) has begun work on a general framework for hybrid mismatch rules that would apply to intra-EU mismatch arrangements involving hybrid entities. The work of the Subgroup has provided valuable guidance on a coordinated approach to addressing hybrid mismatch arrangements.

⁴ Council Doc. 16766/10 (7 Dec 2010).

⁵ Com(2013) 814 final (25 November 2013).

II. DESIGN OF HYBRID MISMATCH RULES

16. Hybrid mismatch arrangements incorporate techniques that exploit a difference in the characterisation of an entity or arrangement under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes. The focus of the Action Plan is on hybrid mismatches that shift profit between jurisdictions or permanently erode the tax base of a jurisdiction. The Action Plan calls for domestic rules designed to put an end to these arrangements. This Part of the Consultation Document identifies the subject matter and scope of the rules and sets out a number of principles for their design. Section 1 describes what a hybrid mismatch is, by reference to the language in Item 2 of the Action Plan. Section 2 sets out the key criteria for assessing rules designed to neutralise the effect of such hybrid mismatch arrangements.

1. What is a Hybrid Mismatch Arrangement?

17. A hybrid mismatch arrangement is a profit shifting arrangement 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 hybrid mismatch arrangements targeted by the rules recommended in this Consultation Document are those where the resulting mismatch results in a lower aggregate tax burden for the parties to the arrangement.

18. The rules set out in this Consultation Document target only instruments and entities that are hybrids for tax purposes and adjust only the tax outcomes under those arrangements. An instrument or entity may produce other hybrid effects (for regulatory or accounting purposes, for example) but these types of hybridity do not impact on the analysis of whether such instruments and arrangements are hybrids for tax purposes. Equally the rules set out under this Consultation Document only impact on the tax treatment of such instruments and do not purport to interfere with the terms of the instruments themselves or their entitlement to qualify for hybrid treatment in any other context. The key elements of a hybrid mismatch arrangement are discussed below.

A. *Arrangement results in a mismatch in the tax treatment of a payment*

19. Action 2 calls for recommendations on the design of domestic rules that address hybrid *mismatch* arrangements. Under Paragraphs (ii) to (iv) of Action 2, Working Party 11 (**WP11**) is asked to recommend domestic rules that would:

- (a) prevent exemption or non-recognition for payments that are deductible by the payer;
- (b) deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); and
- (c) deny a deduction for a payment that is also deductible in another jurisdiction.

20. The two key mismatch arrangements identified in Action 2 are payments that are deductible under the rules of the jurisdiction of the payer and not included in the income of the recipient (so called deduction / no inclusion or **D/NI** outcomes) and payments that give rise to duplicate deductions from the same expenditure (a double deduction or **DD** outcome). Sub-paragraphs (a) and (b) above are effectively opposite sides of the same D/NI arrangement in that the effect of a hybrid mismatch arrangement that gives

rise to a D/NI outcome will be neutralised if the recipient is denied an exemption or other tax relief for the payment *or* the payer is denied the deduction for that payment. While the focus of Action 2 is on arrangements that produce DD and D/NI outcomes, in certain cases, hybrid mismatch arrangements can be more effectively addressed through domestic law changes which address the underlying tax asymmetry at a more fundamental level, for example by re-characterising the entities or arrangements (see, further, the discussion at Section 2E below in relation to minimising disruption to domestic law).

21. All the mismatch arrangements described above involve *payments*. The term “payment” is understood to include any amount capable of being paid including (but not limited to) a distribution, credit, debit or accrual of money or money’s worth but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties.

22. The focus of Action 2 is on arrangements that exploit differences in the way the payment is characterised in the jurisdiction of payment and the jurisdiction of receipt in order to achieve profit shifting and base erosion outcomes. Action 2 is not intended to capture all arrangements that have the effect of lowering the aggregate tax burden of the parties to an arrangement. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to accrue any expenditure (such as regimes that grant “deemed” interest deductions for equity capital) are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2.

B. Arrangement contains a hybrid element

23. To be within the scope of Action 2, the arrangement must be a hybrid arrangement. While cross-border mismatches arise in other contexts (such as the payment of deductible interest to a tax exempt entity) those arrangements are not dealt with in this Consultation Document as they do not rely on a hybrid element to produce D/NI and DD outcomes. As identified in Action 2, hybrid mismatch arrangements can be divided into two distinct categories based on their underlying mechanics: some arrangements involve the use of *hybrid entities*, where the same entity is treated differently under the laws of two or more jurisdictions; and others involve the use of *hybrid instruments*, where there is a conflict in the treatment of the same instrument under the laws of two or more jurisdictions. In both cases the hybrid element leads to a different characterisation of a payment under the laws of different jurisdictions.

24. Conflicts in the treatment of the hybrid entity generally involve a conflict between the transparency or opacity of the entity for tax purposes in relation to a particular payment. Within the category of hybrid instruments there is a further subdivision that can be made between *hybrid transfers*, which are arrangements in relation to an asset where taxpayers in two jurisdictions take mutually incompatible positions in relation to the character of the ownership rights in that asset, and *hybrid financial instruments*, which are financial instruments that result in taxpayers taking mutually incompatible positions in relation to the character of the same payment made under the instrument.

C. Hybrid element causes a mismatch in tax outcomes

25. The hybrid mismatch rule should not apply unless it is the hybrid element that gives rise to the mismatch. In most cases the causal connection between the hybrid element and the mismatch will be obvious. This is generally the case in the hybrid entity context where the mismatch usually involves a conflict between the transparency or opacity of the entity for tax purposes in relation to a particular payment. There are, however, some challenges in identifying the hybrid element in the context of hybrid financial instruments. This point is discussed in further detail in Part IV of the Consultation Document (Hybrid Financial Instruments and Transfers)

D. Mismatch in tax outcomes lowers the aggregate tax paid by the parties to the arrangement

26. The hybrid mismatch rules should not generally interfere with hybrid entities or instruments that produce outcomes that do not raise tax policy concerns. In order to fall within the scope of the rule, the arrangement should result in an erosion of the tax base of one or more jurisdictions where the arrangement is structured. For example, the hybrid mismatch rule limiting D/NI outcomes should not address differences in the timing of payments and receipts under the laws of different jurisdictions and the rules limiting DD outcomes for hybrid entity payments should generally preserve both deductions to the extent they are offset against income that is taxable under the laws of both jurisdictions or to the extent the DD outcome simply results in shifting the net income of the taxpayer from one taxable period to another.

2. Design Principles

27. The hybrid mismatch rules should meet the criteria for good rule design. In particular, the rules should:

- (a) operate to eliminate the mismatch without requiring the jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement;
- (b) be comprehensive;
- (c) apply automatically;
- (d) avoid double taxation through rule co-ordination;
- (e) minimise the disruption to existing domestic law;
- (f) be clear and transparent in their operation;
- (g) facilitate co-ordination with the counterparty jurisdiction while providing the flexibility necessary for the rule to be incorporated into the laws of each jurisdiction;
- (h) be workable for taxpayers and keep compliance costs to a minimum; and
- (i) be easy for tax authorities to administer.

In practice, many of these design principles are complementary. For example, hybrid mismatch rules that apply automatically will be more clear and transparent in their operation and reduce administration costs for tax authorities. Rules that minimise disruption to domestic law will be easier for countries to implement and reduce compliance costs for taxpayers. Each of these design principles is discussed in further detail below.

A. Rules should target the mismatch rather than focusing on establishing in which jurisdiction the tax benefit arises

28. The Action Plan simply calls for the elimination of the DD and D/NI outcomes without requiring the jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement. Action 2 addresses the base erosion and profit shifting outcome by eliminating the mismatch and therefore a taxpayer's incentive to enter into hybrid mismatch arrangements. While neutralising the effect of hybrid mismatch arrangements will address the risks to a jurisdiction's tax base, this will not be achieved by capturing additional revenue under the hybrid mismatch rules themselves, rather the rules are intended to drive taxpayers towards less complicated and more transparent tax structuring that is easier for jurisdictions to address with more orthodox tax policy tools. This approach also avoids the practical and conceptual difficulties in distinguishing between acceptable and unacceptable mismatches or trying to

allocate taxing rights based on the extent to which a country's tax base has been eroded through the hybrid mismatch arrangement.

29. Some domestic hybrid mismatch rules, such as those adopted by the United Kingdom, have an avoidance qualification in that the hybrid mismatch rule only applies where it can be shown that the purpose of the arrangement was to secure a tax benefit in that jurisdiction. This limitation is designed to restrict the impact of the hybrid mismatch rule so that it only operates to the extent necessary to protect the domestic tax base from the effect of such arrangements. Such a qualification will generally be unnecessary, however, in the context of a multilateral approach that is designed to eliminate the mismatch in tax treatment regardless of where the tax benefit arises. Indeed, one of the advantages of adopting a common set of linking rules is that it is no longer necessary to determine to what extent the arrangement has given rise to a tax benefit under the laws of the country applying the hybrid mismatch rule.

B. Comprehensive

30. Hybrid mismatch rules that are not comprehensive will create further tax planning opportunities and additional compliance costs for taxpayers without achieving their intended policy outcomes. The rules should avoid leaving gaps that would allow a taxpayer to structure around them. Taxpayers operating in the cross-border context have the ability to restructure arrangements and transfer ownership of entities and instruments between jurisdictions in order to exploit any gaps in the hybrid mismatch rules. For this reason, this report recommends that every jurisdiction introduces a complete set of rules that are sufficient to neutralise the effect of the hybrid mismatch on a stand-alone basis, without the need to rely on hybrid mismatch rules in the counterparty jurisdiction.

31. Hybrid mismatch rules that are both comprehensive and widespread will be subject to some degree of jurisdictional overlap; while it is important to have rules that are comprehensive and effective, such overlap should not result in double taxation of the same economic income. For this reason, as discussed in Section 2D below, the rules recommended in this report are organised in a hierarchy that switches-off the effect of one rule where there is another rule operating in the counterparty jurisdiction that will be sufficient to address the mismatch. Both primary and secondary rules are required, however, in order to comprehensively address the mismatch, the hierarchy simply addresses the risk of over-taxation in the event the same hybrid mismatch rules apply to the same arrangement in different jurisdictions.

C. Rules should apply automatically

32. The approach adopted in this Consultation Document is that the hybrid mismatch rules should apply automatically to a hybrid mismatch arrangement if it produces a base erosion or profit shifting outcome. Some domestic hybrid mismatch rules, such as those in the United Kingdom, only apply when a tax authority issues a notice stating that the rules will apply. This is a structural feature of rules which require a qualitative assessment of whether the arrangement has been used to erode the domestic tax base of the country applying the rule. This assessment is unnecessary under a multilateral approach which applies the hybrid mismatch rule to any hybrid arrangement that has the effect of lowering the overall global tax rate of parties affected by the arrangement. Automatic rules will be more effective than those that only apply following the exercise of administrative discretion. Rules that apply only on notice would also require some degree of co-ordination between tax authorities, which would increase complexity and make the rules less efficient and consistent in their operation.

D. Co-ordination of rules to avoid double taxation

33. When the rules operate to neutralise a tax benefit arising under a hybrid mismatch, they should only operate so far as is necessary to address the mismatch. Thus the rules should:

- (a) where appropriate, apply an agreed ordering rule to ensure that they apply consistently and proportionately in situations where the counterparty jurisdiction does, or does not, have a similar set of hybrid mismatch rules;
- (b) be applied consistently with other rules of the domestic tax system so that the interaction does not result in double taxation of the same economic income;
- (c) co-ordinate with the rules in a third jurisdiction (such as CFC rules) which subject payments to taxation in the residence state of the investor.

34. The Action Plan calls for “guidance on the co-ordination or tie breaker rules where more than one country seeks to apply such rules to a transaction or structure.” In order to achieve this design outcome, these recommendations contain an ordering rule so that one rule is turned-off when the counterparty jurisdiction with the same set of rules can neutralise the effect of the hybrid mismatch arrangement in a more efficient and practical way. An ordering rule avoids the need for an express tie-breaker and should achieve the necessary degree of co-ordination without resort to the competent authority procedure. Because the focus of the rule is simply on eliminating the mismatch the primacy in the ordering rule has been given to effectiveness and ease of application rather than to the question of which jurisdiction has “lost” tax revenue under the arrangement.

35. Just as the hybrid mismatch rules require co-ordination with hybrid mismatch rules in other jurisdictions they also must be co-ordinated as between themselves and with other specific anti-abuse and re-characterisation rules. These co-ordination issues are addressed in Part VII of this document.

36. Paragraph (iii) of Action states that domestic hybrid mismatch rules that deny a deduction for a payment that is not includible in income by the recipient must take appropriate account of the fact that the payment may be subject to taxation under the controlled foreign company rules operating in the jurisdiction of the recipient’s investor. This requirement is reflected in Part VI of this Consultation Document in relation to reverse hybrid mismatches and other imported mismatch arrangements where the primary recommendation is that income of a reverse hybrid should be brought into account through CFC or other anti-deferral rules under the laws of the investor jurisdiction. This report does not, however, make a similar recommendation in respect of D/NI arrangements arising under hybrid financial instruments, primarily due to concerns about workability and complexity of such a rule in that context.

E. Rules should minimise disruption under existing domestic law

37. One of the challenges in the design of a hybrid mismatch rule is addressing the disruption that it may cause to the existing tax regime. This is a particular challenge in the context of hybrid mismatch arrangements where neutralising the tax effect of the arrangement involves aligning the tax outcomes in jurisdictions that have demonstrably incompatible rules and where the hybrid mismatch rule may not be applied to the same arrangement in a purely domestic context. The rule should therefore seek to align the tax treatment of the arrangement in the affected jurisdictions with as little disruption to domestic law as possible. In order to minimise the impact on other domestic rules a hybrid mismatch rule need do no more than simply reconcile the tax consequences of the hybrid mismatch arrangement. It does not need to address the characterisation of the entity or instrument itself.

38. A country adopting hybrid mismatch rules could choose to go further under domestic law and re-characterise an instrument, entity or arrangement to achieve consistency with domestic law outcomes. Re-characterisation, based on the treatment of the instrument or arrangement under the laws of the other jurisdiction should generally be effective in preventing a mismatch from arising. Such a re-characterisation approach is not necessary to align the ultimate tax outcome in both jurisdictions. In order to minimise the disruption to the rules of other jurisdictions this document limits its recommendations to adjusting the effect of the arrangements (e.g. deny the deduction for, or require the inclusion of, the payment) rather than the character of the entities and instruments under the arrangement.

F. Rules should be clear and transparent

39. The outcome envisaged by Action 2 is that each country will adopt a single set of integrated matching rules that provides for clear and transparent outcomes under the laws of all jurisdictions applying the same rules. The rules must therefore be drafted as simply and clearly as possible so that they can be consistently and easily applied by taxpayers and tax authorities operating in different jurisdictions. This will make it easier for multinationals and other cross-border investors to interpret and apply the hybrid mismatch rules, reducing both compliance costs and transactional risk for taxpayers.

G. Rules should achieve consistency while providing implementation flexibility

40. If the same hybrid mismatch rules are to be applied to the same arrangement by two jurisdictions and they are to co-ordinate the response between them, it will generally be necessary to ensure that the rules in both jurisdictions operate on the same entities and payments. This is a particular challenge when the nature of a hybrid mismatch rule is premised on a mismatch in the characterisation of the payments and entities that are the subject matter of the rule. For this reason, the draft rules should use (where appropriate) jurisdiction neutral terminology that describes the arrangement by reference to the mismatch in outcomes rather than the mechanism used to achieve it. For example, as illustrated in Part V of this Consultation Document, there are a number of different mechanisms that can be used to engineer a DD outcome under a hybrid entity arrangement – in order to achieve consistency in the application of the hybrid entity rule across all jurisdictions the rule needs to be articulated without reference to the mechanism by which the double deduction is achieved under each jurisdiction.

41. The rules must be the same in each jurisdiction while being sufficiently flexible and robust to fit within existing domestic tax systems. To achieve this, hybrid mismatch rules must provide jurisdiction neutral definitions that can be applied to the same entities and arrangements under the laws of two jurisdictions and avoid a level of detail that would make them impossible to implement under the domestic laws of a particular jurisdiction.

42. In considering the design of hybrid mismatch rules it is also relevant to take into account potential constraints under national and international law. In particular the potential for conflicts with international treaty obligations can be mitigated by designing rules so that they target only those arrangements that engineer mismatches which raise genuine policy issues and by ensuring that the substantive outcomes are the same under the hybrid mismatch rule for both residents and non-residents. While the recommendations made in this report are sensitive to national and international law concerns they are a domestic law implementation issue for each country to consider when adopting them.

H. Rules should be workable for taxpayers

43. One of the fundamental principles in the design of any tax rule is that it keeps compliance costs on taxpayers to a minimum. It should be borne in mind that, in most cases, hybrid mismatch arrangements

are structured arrangements that may already have significant costs associated with them. It is expected that, in many cases, the effect of these hybrid mismatch rules will eliminate the tax advantages of entering into these arrangements so that the costs of complying with the rule may, in practice, be reduced. The measurement of compliance costs can, however, depend on how well the rule is targeted. If the rule is drafted in such a way that all instruments and entities must be tested against it, it will impose compliance costs on taxpayers who have not entered into hybrid mismatch arrangements.

44. One of the advantages of dealing with hybrid mismatch arrangements on a multilateral and co-ordinated basis is that compliance costs would reduce significantly after a critical mass of countries adopts the same rule. For example, in the context of hybrid financial instruments, a related party holder of a financial instrument will not have to comply with the secondary rule, which requires the payment to be included in income, if the issuer is located in a jurisdiction that denies the deduction for the payment.

45. Similarly, if countries move from unilateral measures to protect their tax bases to a more co-ordinated approach, that will not only have the effect of reducing the risk posed by these structures to the tax base of all countries, but it should also lead to an overall decrease in transaction costs and tax risks for cross-border investors who might otherwise find themselves exposed to the risk of economic double taxation under a unilateral hybrid mismatch measure adopted by an individual jurisdiction.

I. Rules should be easy for tax authorities to administer

46. While it is expected that there will be costs associated with domestic law implementation, once the rules are in place they should apply automatically on a self-assessment basis and not raise significant on-going administration costs for tax authorities. Furthermore, in many cases, it is expected that these rules should strip hybrid arrangements of their tax benefits which should reduce the costs associated with identifying and responding to these structures. The costs to tax administrations in applying and enforcing the rule depend, however, on having rules that are clear and transparent so that they apply automatically with minimal need for the taxpayer or tax administration to make qualitative judgments about whether an arrangement is within scope.

47. Well drafted rules should improve the coherence of the tax system which can lead to a reduction in tax administration costs. For example, in the case of the hybrid financial instruments, the alignment of tax outcomes should take some pressure off the debt – equity distinction under domestic law. A multilateral and co-ordinated approach would also reduce administration costs as it would enable one tax authority to quickly understand the rule being applied in the other jurisdiction. The work being done as part of Action 12 on mandatory disclosure may also make it easier for tax authorities to collect and exchange information on both the structure of arrangements and the payments made under them.

Box 1. Questions for Consultation

1. Are the objectives and design principles of the hybrid mismatch arrangements clear?
2. If further clarification is required, then where is this required and how could it best be provided?

III. GENERAL OVERVIEW OF DESIGN RECOMMENDATIONS

48. The approach adopted in this Consultation Document is to identify and categorise hybrid mismatch arrangements based on the particular hybrid technique that produces the profit shifting and / or base erosion outcome and to set out recommendations for domestic rules that would neutralise the effect of any arrangement incorporating that technique.

49. The recommendations in the Consultation Document target three categories of hybrid mismatch arrangement:

- (a) *Hybrid financial instruments* (including transfers); where a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction;
- (b) *Hybrid entity payments*, where differences in the characterisation of the hybrid payer result in a deductible payment being disregarded or triggering a second deduction in the other jurisdiction;
- (c) *Reverse hybrid and imported mismatches*, which cover payments made to an intermediary payee that are not taxable on receipt. There are two kinds of arrangement targeted by these rules:
 - (i) arrangements where differences in the characterisation of the intermediary result in the payment being disregarded in both the intermediary jurisdiction and the investor's jurisdiction (reverse hybrids);
 - (ii) arrangements where the intermediary is party to a separate hybrid mismatch arrangement and the payment is set-off against a deduction arising under that arrangement (imported mismatches).

50. These categories describe, in general terms, the various ways in which a hybrid technique can be used to engineer a mismatch in tax outcomes. *Hybrid financial instruments* rely on differences in the way jurisdictions characterise payments made under the instrument, while hybrid entity payments and payments to a reverse hybrid achieve a mismatch in tax outcomes by exploiting differences in the way the payer or payee is taxed under the laws of two or more jurisdictions. For *hybrid entity payments* the technique involves exploiting differences in the treatment of the payer while for *reverse hybrids* the technique takes advantage of differences in the treatment of the payee. Finally, *imported mismatches*, are mismatches that are engineered under the laws of another jurisdiction and imported into the jurisdiction of the payer.

1. Recommendations

51. Table 1 at the end of this Part III, provides a general overview of the categories of hybrid mismatch arrangement and the recommendations for domestic rules designed to neutralise their effect. The table identifies for each category of arrangement: the hybrid element that gives rise to the mismatch in outcomes and the nature of the resulting mismatch. The table then summarises the specific recommendation for changes to domestic law and the linking rules designed to eliminate the mismatch.

A. Mechanics

52. This Consultation Document recommends changes to domestic law designed to reduce the incidence of hybrid mismatches and linking rules that specifically target the mismatch in tax outcomes under hybrid mismatch arrangements. In order to guard against the risk of double taxation, the Consultation Document recommends that the linking rules be divided into a primary rule, which would apply whenever a hybrid mismatch arose, and a secondary or defensive rule, which would only apply in circumstances where the primary rule did not apply in the jurisdiction of the counterparty. The choice of primary and defensive rules is based on ensuring that the hybrid mismatch rules are effective and relatively easy to apply, rather than looking to compensate the jurisdiction that has lost tax revenue under the arrangement.

B. Scope

53. While the design recommendations call for rules that are both clear and comprehensive, overly broad hybrid mismatch rules may be difficult to apply and administer. These compliance and operational challenges vary in accordance with the mechanics of the rule, the nature of the arrangement it applies to and the position of the taxpayer under the arrangement. The differences in compliance costs and risks for different arrangements and taxpayers mean that the question of the scope of each rule must be considered on a rule by rule basis.

54. Each linking rule, for example, has its own information requirements. The linking rule for hybrid financial instruments focuses on the character of the instrument for foreign law purposes rather than the particulars of the counterparty and how it has treated the payment. On the other hand, the rules designed to neutralise the effect of payments to reverse hybrids may require specific and detailed information on the character of both the intermediary and investor and how they have treated a specific payment under the laws of their own jurisdiction.

55. The specific compliance costs and risks presented by a hybrid mismatch rule will also depend on the nature of the arrangement and the role played by the taxpayer under that arrangement. As discussed in Part IV, a single financial instrument could have a large number of holders. These holders may further be able to transfer their interest in the instrument to others without the consent of the issuer. Because the relationship between the issuer and holders in this case is *one to many* and can change over time it will generally be easier for holders to obtain tax information about the issuer than for the issuer to obtain information about the tax position of each holder. Similar concerns apply in respect of the potential impact of the hybrid entity rules to collective investment vehicles such as funds where an investor might be expected to have access to accurate and timely information about the tax treatment of the fund but the fund may not have an equivalent level of access to similar information about its investors. These asymmetries in information flow may justify the adoption of different hybrid mismatch rules of different scope and variations in the scope of the primary and secondary rule based on the particular position of the taxpayer.

56. Further, some taxpayers may be in a better position than others to manage the risk associated with the potential application of a hybrid mismatch rule. Part V of the Consultation Document, which discusses payments made by hybrid entities, notes that it is a relatively simple matter to deny an investor the duplicate deduction incurred through a hybrid entity such as a fund, while, in the same circumstances, it may prove unduly burdensome for the fund to lose the full benefit of its deduction under the hybrid mismatch rule simply because a minority foreign investor has, without the consent or knowledge of the fund, claimed a deduction for a portion of that expenditure under the laws of its own jurisdiction. For this reason, the linking rule for DD hybrid entity payments has a narrower scope in the subsidiary jurisdiction than the linking rule in the investor jurisdiction.

57. As noted in Table 1 below each hybrid mismatch rule has a different recommended scope. A more detailed discussion of the scope of each rule is set out in Parts IV to VI of this Consultation Document. The table also notes that the appropriate scope of the hybrid financial instrument rule is still being explored.

2. Detailed Description and Technical Analysis

58. The remainder of this Consultation Document explains these recommendations in more detail. Parts IV, V and VI set out, in respect of the recommendations for each type of hybrid mismatch arrangement:

- (a) an explanation of the arrangements the hybrid mismatch rule is intended to cover;
- (b) the recommendations on rules designed to eliminate the mismatch, including a linking rule designed to neutralise its effect;
- (c) further technical explanation of the rules; and
- (d) examples that illustrate how the recommendations would operate in practice.

Part VII this report contains further technical explanation on certain aspects of the recommendations.

Table 1. Summary of Recommendations

Category	Hybrid element	Type of Mismatch	Recommended changes to domestic law	Recommended Linking rule		
				Primary Response	Defensive rule	Scope
Hybrid Financial Instruments & Transfers	Differences in the tax treatment of the instrument mean that payments under the instrument have a different character	D/NI	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Payer jurisdiction denies deduction	Payee jurisdiction includes payment as income	Under consideration
Hybrid entity payments	Differences in the tax treatment of the entity or arrangement mean that payments made by the entity or under the arrangement are characterised differently under the laws of two or more jurisdictions.	D/NI	-	Payer jurisdiction denies deduction	Payee jurisdiction includes payment as income	Related parties (incl. persons acting in concert) & structured arrangements.
		DD	-	Investor jurisdiction denies deduction	Subsidiary jurisdiction denies deduction	Primary rule no limitation. Defensive rule limits to related parties (incl. persons acting in concert) & structured arrangements.
Reverse hybrids	Differences in the tax treatment of the entity mean that payment is not included in income by the payee	D/NI	Intermediate jurisdiction implements tax filing and information requirements	Investor required to include income Intermediate jurisdiction follows tax treatment of controlling investor if no inclusion by that investor	Payer jurisdiction denies deduction	Members of controlled group (incl. persons acting in concert) and anti-abuse
Imported mismatches	Payment is offset against expenditure incurred under a hybrid mismatch arrangement.			Introduce anti-hybrid rules		

IV. HYBRID FINANCIAL INSTRUMENTS & TRANSFERS

59. This Part sets out recommendations for the design of hybrid mismatch rules designed to neutralise the effect of hybrid financial instruments.

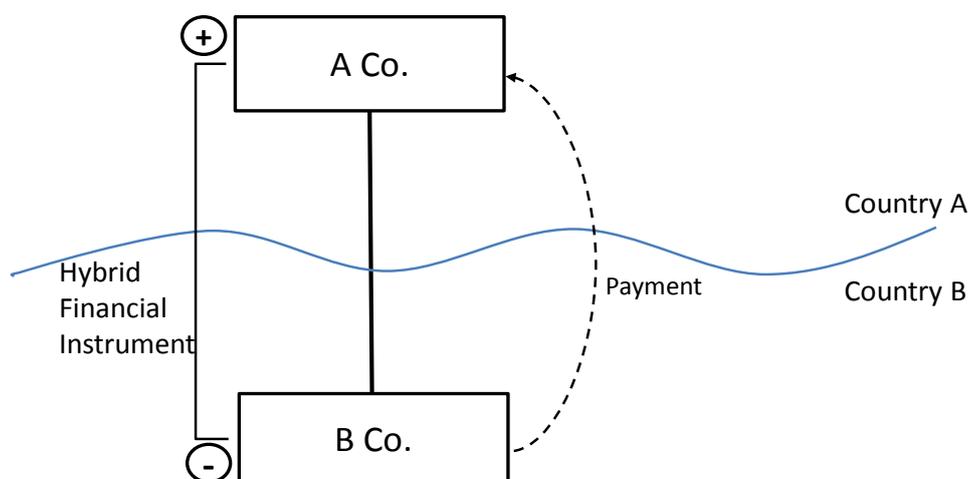
1. Description of Hybrid Mismatch Arrangement

60. A hybrid financial instrument is any financing arrangement that is subject to a different tax characterisation under the law of two or more jurisdictions such that a payment under that instrument gives rise to a mismatch in tax outcomes.

A. Basic hybrid financial instrument

61. A simplified illustration of a mismatch arrangement involving the use of a hybrid financial instrument is set out below:

Figure 1. Hybrid Financial Instrument



62. In this example B Co (an entity resident in Country B) issues a hybrid financial instrument to A Co (an entity resident in Country A). The instrument is treated as debt for the purposes of Country B law and Country B grants a deduction for interest payments made under the instrument, while Country A law grants some form of tax relief (an exemption, exclusion, indirect tax credit, etc.) in relation to the interest payments received under that instrument.

63. This mismatch can be due to a number of reasons. Most commonly the financial instrument is treated by the issuer as *debt* (i.e. a claim against the issuer) and by the holder as *equity* (i.e. an interest in the issuer). This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief. In the example illustrated above in Figure 1, the entities

treated as the payer and the payee under the instrument are the same under the domestic laws of both jurisdictions. It is possible, however, to engineer a hybrid financial instrument where the entity treated as the payer or the payee is different under the laws of each jurisdiction. An example of this kind of structure involving a hybrid financial instruments issued by partnership is discussed further in the technical discussion in Part VII of the Consultation Document.

64. In other cases the mismatch in tax outcomes may not be attributable to a general difference in the way the instrument is characterised for tax purposes but rather to a specific difference in the tax treatment of a particular payment made under the instrument. Examples of such instruments and payments include:

- (a) a subscription or sale of shares with a deferred purchase price component that is treated as giving rise to a deductible expense for the share subscriber and a non-taxable receipt for the share issuer;
- (b) a deduction claimed by an issuer for the premium paid on converting a mandatory convertible note, while the holder of the note treats the premium as an exempt gain;
- (c) an issuer that claims a deduction for the value of an embedded option in an optional convertible note while the holder ignores the value of the option component (or gives it a lower value than the issuer);
- (d) an issuer that bifurcates an interest free shareholder loan into its equity and debt components and then accrues the equity component over the life of the loan while the holder treats the entire amount as a loan for the principal sum.

In these kinds of mismatches both jurisdictions treat the instrument as having the same general character (a debt instrument). Technical differences in the way each jurisdiction taxes such instruments, however, mean that certain payments made under the instrument will give rise to D/NI outcomes.

B. Hybrid transfers

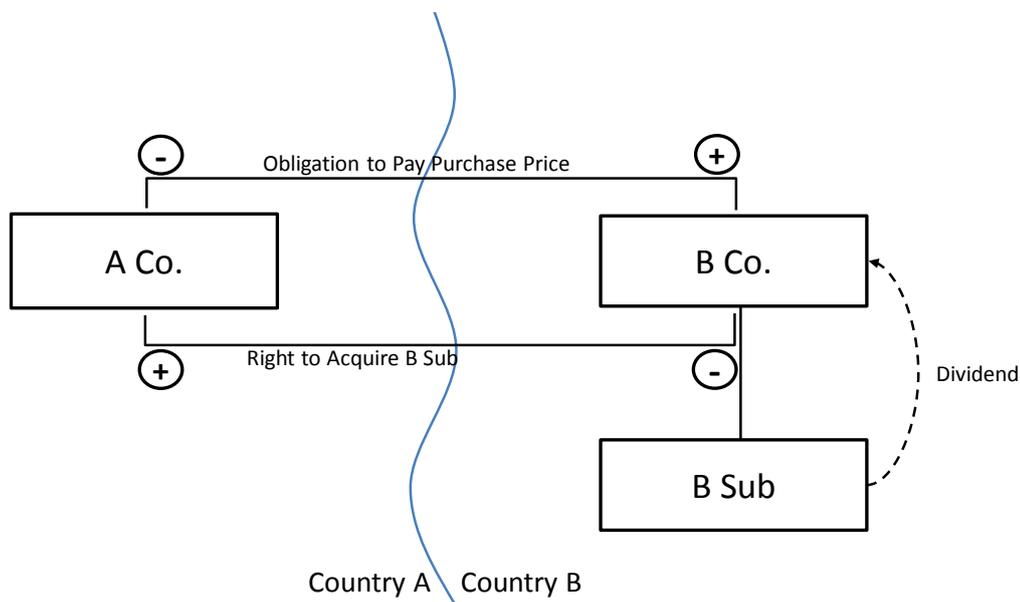
65. Hybrid transfers are typically a particular type of collateralised loan arrangement or derivative transaction where the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of the loan collateral or subject matter of the derivative. This difference in the way the arrangement is characterised can lead to payments made under the instrument producing D/NI outcomes.

(a) Collateralised loan repo

66. While the legal mechanisms for achieving a hybrid transfer depend on the individual complexities of the tax rules of the jurisdictions involved, the most common transaction used to achieve a mismatch in tax outcomes under a hybrid transfer is a sale and repurchase arrangement (generally referred to as a “repo”) over an asset where the terms of the repo make it the economic equivalent to a collateralised loan. The way the repo is structured, however, generally results in one jurisdiction treating the arrangement in accordance with its form (a sale and a repurchase of the asset) while the counterparty jurisdiction taxes the arrangement in accordance with its economic substance (a loan with the asset serving as collateral). While the collateral for these arrangements often involves shares of controlled entities, the same repo technique can be used with virtually any asset that generates an excluded or exempt return or some other tax relief under the laws of both jurisdictions.

67. A basic example of such a structure, taken from the Hybrids Report, is illustrated in Figure 2 below.

Figure 2. Collateralised Loan Repo



68. The structure illustrated in Figure 2 involves a company in Country A (A Co) which owns a subsidiary (B Sub). A sells the shares of B Sub (or a class of shares in B Sub) to B Co under an arrangement that A Co (or an affiliate) will acquire those shares at a future date for an agreed price. Between sale and repurchase, B Sub earns income, pays tax and makes distributions on the shares to B Co.

69. Country B taxes the arrangement in accordance with its form. Accordingly B Co is treated as the owner of the B Sub shares and entitled to receive and retain the dividends paid by B Sub during the life of the repo. Country B will typically grant a credit, exclusion, exemption or some other tax relief to B Co on the dividends received. B Co also treats the transfer of the shares back to A Co as a genuine sale of shares and may exempt any gain on disposal under an equity participation exemption or a general exclusion for capital gains.

70. Country A taxes the arrangement in accordance with its economic substance. For Country A tax purposes:

- (a) The transaction is treated as a loan by B Co to A Co that is secured through B Co's holding of the B Sub shares. A Co is thus regarded as being the owner of the B Sub shares with the corresponding entitlement to B Sub dividends during the life of the repo.
- (b) Because Country A treats A Co as the owner of B Sub shares, it requires A Co to include the amount of any dividends paid by B Sub to B Co in A Co's income, however the income tax on this dividend will generally be sheltered by a credit, exclusion or other tax relief applicable to those dividends under the laws of Country A.
- (c) The net cost of the repo to A Co is treated as a deductible financing cost. This cost includes the dividends treated as economically derived by A Co that are paid to and retained by B Co from B Sub but which, for Country A purposes, are treated as paid by A Co to B Co during the life of the repo. Because Country A treats A Co as having paid the amount of the dividend across to B Co, Country A grants a deduction for the amount of the dividend paid to and retained by B Co.

71. The net effect of this repo can be illustrated below. Assume B Sub is a company that is tax resident in Country B and A Co sells the shares to B Co under a repo. The simplified calculation below assumes that B Sub holds assets worth \$1,000 which generate a 10% return and that both Country A and Country B have a 30% tax rate.

Table 2. Taxation of a Collateralised Loan Repo

	B Sub		A Co		B Co	
Net income calculation	Income	100	Dividend from B Sub	70	Dividend from B Sub	70
			Foreign tax credit	30		
			Net income	100		
			Interest paid to B Co	(70)		
Net taxable income		100		30		0
Tax at 30%		(30)		(9)		0
Foreign tax credit				30		
Country A net credit		0		21		0
Country B (net tax)		(30)		0		0

72. As illustrated in the table above, B Sub earns income of \$100 and pays \$30 of Country B income taxes. It then pays a dividend of \$70 to B Co. A Co includes a total dividend of \$100 in its taxable income (including an indirect tax credit of \$30) but is able to claim a deduction of \$70 for the financing expense paid to B Co. As a result, A Co has net taxable income of \$30 and a total Country A tax liability of \$9. A Co can, however, use the underlying tax credit to eliminate this liability and still be left with a further \$21 of surplus credits to offset against tax on other income.

73. Because the net effect of this arrangement is to generate excess tax credits for underlying tax paid by B Co, this kind of structure is commonly referred to as a “tax credit generator.” The surplus tax credits are due, however, to the mismatch between the deductible financing costs incurred by A Co in Country A and the exemption / exclusion of the same amounts under Country B law. Thus, while the net outcome is “surplus” tax credits under the law of Country A, this is simply the product of the underlying D/NI mismatch outcome.

(b) Variations in payments

74. In the example illustrated above the dividend payment by B Sub triggers three different tax consequences under the laws of Country A and B: under Country A law it is treated as both a dividend payment to A Co and a deductible interest expense of A Co. Under Country B law it is treated as an exempt dividend payment to B Co. The D/NI mismatch in the above example arises from the fact the same payment is deductible under the laws of Country A, but exempt from tax in Country B. A transaction with the same economic and tax effect could be achieved utilising an exemption for capital gains on the sale of shares under Country B law. This could be achieved by substituting the dividend paid by B Sub with an increased premium paid by A Co to acquire the B Sub shares at the termination of the repo. An example of collateralised loan repo using a tax exemption for capital gains is set out in the Technical Discussion in Part VII.

(c) *Share lending repo*

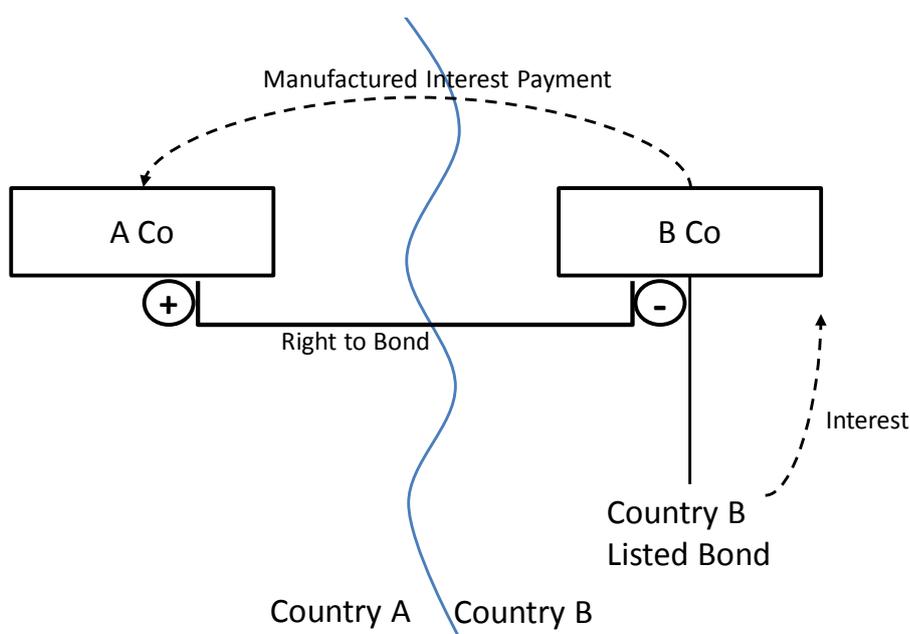
75. As illustrated in the Technical Discussion in Part VII, it is also possible to change the terms of the repo into a share lending arrangement so that the entity acquiring the shares (B Co in the above example) becomes the borrower under the repo and makes D/NI payments to the entity selling the shares (A Co in the above example).

(d) *Double dips of withholding tax credits*

76. Because of their hybrid nature, repo transactions can also be used to double dip on whatever domestic tax relief (typically a tax credit) the jurisdiction of residence provides for taxes withheld on payments at source. Such double-dip tax credit structures do not rely on mismatch in the treatment of payments made under the repo but the double dip is still a product of the hybrid nature of the arrangement in that two jurisdictions provide for double taxation relief on the same payment.

77. The example below illustrates a double dip tax credit structure using a repo over domestic bonds.

Figure 3. Bond Lending Repo – Tax Credit Double Dip



78. In contrast to the collateralised loan repo, the acquirer of the asset (B Co) in this example does not advance funds to the transferor (A Co) at the outset of the arrangement. Rather the obligations of B Co remain outstanding during the term of the arrangement and are generally secured by B Co posting cash or other collateral to an account controlled by A Co. B Co's obligations will generally include the requirement to make "manufactured payments" to A Co of any interest payments on the bonds during the period of the loan (the "manufactured payment").

79. Assume that the payment of \$100 of interest on the bond is subject to 10% withholding tax at source that is creditable against B Co's tax liability. B Co makes a manufactured payment of the interest payment (less withholding) to A Co. A Co treats the manufactured payment as a payment of

interest that has been subject to foreign withholding taxes. A simplified tax calculation showing the net effect of this arrangement is set out below.

Table 3 – Double Dip of Withholding Tax Credits in a Bond Lending Transaction

	A Co		B Co	
Net income calculation	Manufactured payment	90	Interest payment	90
	Withholding tax	10	Withholding tax	10
			Manufactured payment	(90)
Net taxable income		100		10
Tax at 30%		(30)		(3)
Tax Credit		10		10
Net Tax	Country A	(20)	Country B	7

80. If A Co held the Country B listed bond directly then the \$100 interest payment should result in a combined tax liability of \$30 (\$20 of the tax payable under Country A law and \$10 of withholding tax payable in Country B). Because of the repo transaction, however, there is a net \$23 of tax paid (\$20 in Country A and \$3 in Country B) with a surplus \$7 tax credit for B Co that can be refunded or offset against other income. In this example the arrangement is not the product of a D/Ni structure, as both Country A and B treat all amounts received under the arrangement as ordinary income, nevertheless the double-dip on withholding tax credits is a product of a mismatch in tax treatment that is attributable to the hybrid element embedded in the arrangement.

2. Summary of Recommendations

81. The response recommended in this Consultation Document is to neutralise the effect of mismatches that arise under hybrid financial instruments through the adoption of a linking rule that would seek to align the tax outcomes for the payer and payee under a financial instrument. The Consultation Document recommends that the primary response should be to deny the payer a deduction for payments made under a hybrid financial instrument with the jurisdiction of receipt applying a secondary or defensive rule that would require a deductible payment to be included in income in the event the payer was located in a jurisdiction that did not apply the primary rule. The Consultation Document further recommends that jurisdictions that have a dividend exemption as part of their policy to alleviate double taxation should not apply the exemption to deductible payments as a matter of domestic law. Because hybrid transfers are, in effect, a species of financial instrument, this Consultation Document recommends that they should be included within the linking rule. The complete summary of recommendations is set out in the box below.

Recommendations for Neutralising the Effect of Hybrid Financial instruments

Hybrid financial instrument rule

- a) Jurisdictions should deny a deduction for any payment made under a hybrid financial instrument to the extent that the payee does not include the payment as ordinary income under the laws of any jurisdiction.
- b) Jurisdictions should require a payee to include any payment made under a hybrid financial instrument as ordinary income to the extent that the payer is entitled to claim a deduction for such payment (or equivalent tax relief) and the payer's jurisdiction does not apply a hybrid mismatch rule in accordance with recommendation (a) above.
- c) A dividend exemption should not be granted under domestic law to the extent it is a deductible payment so that, in these situations, no mismatch will arise.

Hybrid financial instrument

- d) The kinds of financial instruments caught by the rule should be left to domestic law but the hybrid financial instrument rule should at least include anything that is treated as a debt or equity under the laws of the jurisdiction applying the rule. The definition should also include, where appropriate, arrangements that taxpayers use as alternatives to debt and equity.
- e) A hybrid financial instrument should be defined broadly so as to capture any financial instrument (including a hybrid transfer) where a payment made under the arrangement is deductible in the payer's jurisdiction but not included by the recipient as ordinary income when the recipient calculates its net income for tax purposes. A financial instrument should be treated as 'hybrid' for these purposes if the same arrangement directly entered into between resident taxpayers of ordinary status in their respective jurisdictions would have been sufficient to bring about the mismatch in tax outcomes.
- f) A hybrid transfer should be defined as any arrangement entered into by a taxpayer with another party in respect of an asset where:
 - the taxpayer is the owner of an asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and
 - under the laws of the counterparty jurisdiction the counterparty is the owner of an asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty.

Ownership of an asset for tax purposes should include any rules that result in the taxpayer being taxed as the beneficial owner of the corresponding cash-flows from the asset.

82. Further, in order to prevent taxpayers in a repo transaction claiming two tax credits in respect of the same source taxation, this Consultation Document recommends that a taxpayer's entitlement to direct tax credits under a hybrid transfer be restricted in proportion to the taxpayer's net income under the arrangement (see the box below).

Further Recommendations for Neutralising the Effect of Hybrid Financial Instruments

- a) Any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should introduce rules that would restrict the benefit of such relief in proportion to the net taxable income under the arrangement.

3. Technical Discussion

83. The hybrid financial instrument rule is a linking rule that seeks to align the tax outcomes in the payer and payee jurisdiction where differences in the application of domestic law produce a mismatch in tax outcomes.

- (a) Paragraph (a) of the rule provides that a payment which is ordinarily deductible under the domestic law of the payer's jurisdiction should not be eligible for deduction to the extent the payment is not included in ordinary income under the domestic law of the payee's jurisdiction.
- (b) Paragraph (b) of the rule provides that a payment (to which the rule in paragraph (a) does not apply) should be included as "ordinary income" (i.e. it should not be eligible for any exemption, exclusion or other tax relief under domestic law) to the extent it is deductible under the domestic law of the payer's jurisdiction.

84. When applying its domestic law to such payments the Consultation Document further recommends that jurisdictions which offer an exemption for dividends do not extend that exemption to deductible payments. The payee jurisdiction should not be required to extend relief from economic double taxation under domestic law in circumstances where the payment has not borne underlying tax. Accordingly jurisdictions should modify the definition of a dividend under domestic law or the eligibility of such dividend for preferential tax treatment without limiting the scope of any such response (as discussed further in Section 5 below). When the dividend exemption is denied there will be no mismatch in tax outcomes to which the linking rule can apply and no circularity will arise under the recommended rules.

85. As part of the overall considerations as to the appropriate scope of the hybrid financial instrument rule further consideration could be given to whether a recommendation in respect of the dividend exemption should apply to other types of double tax relief granted for dividends and whether the denial of such tax relief strikes an appropriate balance between the taxing jurisdictions of the payer and the payee.

B. Payments caught by the hybrid mismatch rule

86. Paragraphs (a) and (b) above refer to "payments". Payments caught by the hybrid financial instrument rule should include any kind of accrual, credit, debit or distribution of money or money's worth. Thus, the payer should not be able to claim a deduction for an amount that is accrued but unpaid if a corresponding amount is not taken into account as ordinary income by the holder of the instrument.

87. The mismatch targeted by the hybrid financial instrument rule involves a basic comparison between the proportion of payments that are deductible by the issuer over the life of the arrangement and the proportion included by the holder as ordinary income.

(a) No impact on timing

88. The recommendation is not intended to impact on questions of timing in the recognition of payments. Thus a hybrid mismatch does not arise simply because the issuer accrues original issue discount over the term of the bond while the holder only recognises the corresponding income as redemption premium once the bond is repaid.

(b) No impact of foreign exchange fluctuations

89. The amount of a payment is measured in “money” and the rule should not apply to differences in the way jurisdictions measure the value of money paid under a financial instrument. Mismatches that arise due to foreign exchange movements are not caught by the rule because such fluctuations are not attributable to differences in the amounts paid under an instrument but in differences in the measurement of those amounts.

(c) Differences in valuation are caught if they are differences in the amount of money

90. The hybrid financial instrument should, however, capture differences in the amount attributable to a financial instrument if the difference is attributable to differences in the value of the payment (as calculated in money). Thus differences in the valuation of discount under a non-interest bearing loan note should, for example, fall within the scope of the rule.

C. Deductions and ordinary income

91. Paragraphs (a) and (b) state that the hybrid financial instrument rule should apply to any payment that is deductible under the laws of the payer’s jurisdiction but not included in ordinary income of the holder’s jurisdiction.

(a) What is deductible?

92. The concept of “deduction” and “deductible” are intended to refer to an item of expenditure that is taken into account under the laws of the taxpayer’s state in calculating the taxpayer’s net income. The definition includes “equivalent tax relief” in order to cover relief that is economically equivalent to a deduction such as a tax credit for dividends paid.

93. The recommendation focusses on whether a payment falls into the category of a “deductible” item under the laws of the relevant jurisdiction and the jurisdiction specific details of the taxpayer’s net income calculation should not generally affect the question of whether a payment is deductible for tax purposes. As discussed in the example illustrated in Figure 4 below, a payment will be deductible even if the entity incurring the expenditure is exempt from tax and does not therefore benefit from the deduction or file a tax return.

(b) What is included in ordinary income?

94. Similarly the corresponding requirement that a deductible payment be treated as “ordinary income” by the recipient means that the payment has been incorporated into a calculation of the recipient’s net income under the laws of the relevant tax jurisdiction. Ordinary income in this context means income that is subject to tax at the taxpayer’s full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as credits for underlying tax paid by the issuer). Tax exemptions granted to entities such as charities are not caught by the hybrid financial instrument rule because such exemptions are attributable to a particular characteristic of the taxpayer, rather than a particular category of payment.

95. The jurisdiction specific details of how the taxpayer calculates its income tax liability and at what tax rate should not generally affect the question of whether a payment has been brought into account in calculating that taxpayer’s income. Thus a payment that is offset against deductible expenditure or losses that have been carried forward would, on this definition, be treated as having been brought into account. Similarly a payment will be treated as having been brought into account as ordinary

income even if it is derived by an entity that is exempt from tax on ordinary income or subject to tax on such income at a nil marginal rate.

D. Rule only targets mismatches attributable to hybrid financial instruments

96. There are two key limitations to the rule designed to ensure that the hybrid financial instrument rule neutralises only those mismatches that arise under financial instruments:

- (a) The first limitation operates by way of definition and ensures that the mismatch is attributable to a hybrid element in the financial instrument itself.
- (b) The second limitation operates by way of response and ensures that the rule only neutralises the effect of mismatches that are attributable to the hybrid financial instrument.

(a) Mismatch must be attributable to a hybrid financial instrument

97. The hybrid financial instrument rule should only apply to those mismatches that are attributable to a hybrid element in the instrument itself. While the hybrid element is reasonably easy to isolate and define in respect of hybrid transfers, there is more of a challenge in the context of basic hybrid financial instruments that simply rely on differences in the tax treatment of debt instruments. The recommendation set out in this Consultation Document is that the hybrid element should be identified by elimination; focussing exclusively on the terms of the arrangement between the parties rather than any particular feature of the taxpayer. The test recommended in this Consultation Document is whether the terms of the arrangement in isolation would have been sufficient to bring about the mismatch in tax outcomes under the laws of the relevant jurisdictions. This formulation might suggest the following basic test as set out at paragraph (e) of the recommendations:

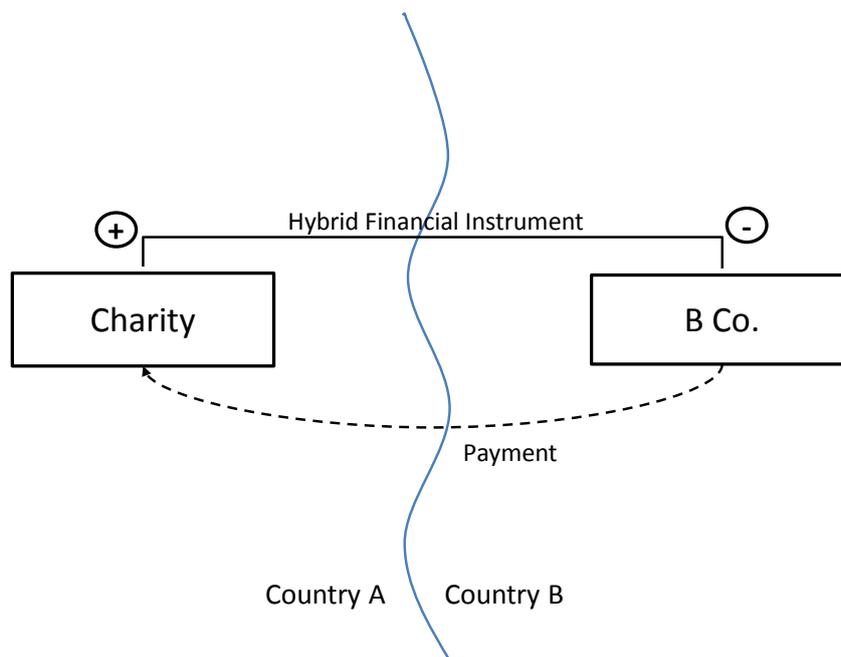
... a financial instrument will be hybrid if the same arrangement directly entered into between resident taxpayers of ordinary status in their respective jurisdiction, would have been sufficient to bring about the mismatch.

98. Although there may be other factors, outside the terms of the arrangement, that were sufficient to bring about the mismatch (such as the fact that the holder is tax exempt under the laws of its jurisdiction or holds the instrument under a foreign branch exemption) these factors will not prevent the instrument being treated as a hybrid financial arrangement (as defined) provided the terms of the financing arrangement on its own, were sufficient to bring about the D/NI outcome.

(b) Rule only neutralises mismatches attributable to the hybrid financial instrument

99. Not only does the rule proposed in the Consultation Document restrict its application to hybrid financial instruments, the suggested response set out in the Consultation Document is designed to limit the effect of the hybrid mismatch rule to mismatches that are the product of the hybrid element in the financial arrangement. The rule does not guarantee that the payment will result in increased tax liability for the payer or the payee. If, in practice, a taxpayer is not subject to tax on ordinary income (because, for example, it is a tax exempt entity) then the application of the hybrid mismatch rule will not result in any additional tax liability for the taxpayer. The example below illustrates the overall effect of this approach:

Figure 4. Application of the Hybrid Financial Instrument Rule to a Tax Exempt Holder



100. Charity, a tax exempt entity resident in Country A, lends money to B under a hybrid financial instrument (i.e. an instrument that would have led to a D/NI outcome if it had been entered between ordinary taxpayers). The instrument is a “hybrid financial instrument” for the purposes of these rules because the terms of the instrument are sufficient to bring about a D/NI outcome. Country B would accordingly be able to apply its hybrid mismatch rule to deny the deduction to B Co for the payment made under the hybrid financial instrument notwithstanding that the overall outcome would have been the same if the instrument had not been a hybrid financial instrument (because Charity is tax exempt).

101. Country A would also treat the loan as a hybrid financial instrument so that, Country A would apply the defensive rule under its domestic law (in the event that Country B did not apply the primary rule to deny the deduction for the interest payment made by B Co). The effect of treating the loan as a hybrid financial instrument in this case, however, is that Charity would be required to treat the interest payments as “ordinary income”. Charity is exempt from tax on ordinary income, so the proper application of the hybrid mismatch rule will not result in any additional tax liability for Charity.

102. The lending and payment flows could be reversed so that the Charity is the payer under the hybrid financial instrument. In this case the primary rule (denial of the deduction in Country A) would have no effect on Charity as Charity is not subject to net income taxation under the laws of Country A and, provided the hybrid mismatch rule has been properly applied to the hybrid financial instrument in Country A, there should be no need for Country B to apply the secondary rule. This outcome ensures that there is no need for B Co, in this example, to make an enquiry into the actual tax treatment of the payment by Charity in circumstances where Country A applies the primary response under the hybrid financial instrument rule.

E. Rule only applies to the extent of the mismatch

103. The hybrid mismatch rules only apply to reverse the tax effect of D/NI arrangements “to the extent” the deductible payment is not included in ordinary income. The methodology for calculating

the extent of the adjustment required to eliminate the mismatch will generally be a matter for domestic law implementation and administrative guidance. In general, however, complexity should be avoided and jurisdictions should endeavour to apply robust and transparent rules that are easy for taxpayers to interpret and apply.

F. Framework for determining whether an instrument is a hybrid financial instrument

104. The above discussion therefore suggests the following overall 4 step approach to the design of the hybrid financial instruments rule:

(a) *Define what is meant by a "financial instrument".*

105. The rule should define the arrangements that are within scope. This should at least include instruments that are treated as either debt or equity under domestic law.

(b) *Does the payment under the instrument give rise to a mismatch?*

106. The rule should identify those payments made under the instrument that are deductible under the laws of one jurisdiction but not taken into account as taxable income under the laws of any jurisdiction (i.e. if the payment is brought into account as ordinary income in at least one jurisdiction then there is no hybrid financial instrument).

(c) *Is the mismatch attributable to a hybrid element in the financial arrangement?*

107. The hybrid mismatch rule should not apply unless the mismatch is a product of the terms of the arrangement itself rather than a particular feature of the taxpayer. The test is a counterfactual one (i.e. whether the mismatch would have arisen if the same arrangement had been directly entered into between ordinary taxpayers resident in the relevant jurisdiction).

(d) *Neutralise the effect of the hybrid financial instrument by aligning tax treatment of the payments made under it.*

108. The effect of the rule should be to re-characterise the payment under the instrument so it has the same character as the payment in the counterparty's jurisdiction.

(a) If the payee's jurisdiction treats a portion of the payments made under instruments of that nature as giving rise to an excluded or exempt return (or as carrying an entitlement to underlying foreign tax credits) then the same proportion of the payments under that instrument should not be treated as a deductible expense of the payer.

(b) If the payer's jurisdiction does not apply the primary rule then the payee's jurisdiction should treat the same proportion of payments as ordinary income (i.e. as not giving rise to an excluded or exempt return or as carrying an entitlement to underlying foreign tax credits).

4. Application of the Rule

A. Basic hybrid financial instrument

109. The effect of introducing these recommendations into Country A law on a basic hybrid financial instrument structure as illustrated in Figure 1 would be as follows:

- (a) Country A would deny the holder the benefit of any domestic dividend exemption if the dividend was deductible by the issuer of the financial instrument. In most cases, this should be sufficient to eliminate the mismatch attributable to a dividend exemption and there would be no need for Country A or Country B to apply the hybrid mismatch rule.
- (b) In the event that the mismatch was not attributable to a dividend exemption in Country A, the hybrid mismatch rule would require A Co to re-characterise the payments made under the instrument as ordinary income to the extent such payment gave rise to a deduction under the laws of Country B and the hybrid mismatch rule (if any) in Country B did not apply to the financial instrument.

110. The effect of introducing these recommendations into Country B law on a basic hybrid financial instrument structure as illustrated in Figure 1 would be as follows:

- (a) If the denial of a domestic dividend exemption in Country A is sufficient to eliminate the mismatch there would be no need for Country B to apply the hybrid mismatch rule.
- (b) In the event that the mismatch was not attributable to a dividend exemption in Country A, the hybrid mismatch rule would deny B Co a deduction for the payment to the extent such payment was not treated as ordinary income (i.e. the payment was exempt, disregarded or subject to some other form of tax relief or characterisation that excluded the income from tax in the recipient jurisdiction).

B. Collateralised loan repo

111. The effect of introducing these recommendations into Country A law on a collateralised loan repo as illustrated in Figure 2 would be as follows:

- (a) The dividend exemption should not apply because the issuer (B Sub) does not claim a deduction for the dividend payment.
- (b) The arrangement between A Co and B Co is a hybrid transfer because:
 - (i) under the laws of Country A, A Co is the owner of the shares in B Sub and the rights of B Co in those shares are treated as obligations of A Co (a grant of a security interest by A Co in respect of a loan). Because of the extended definition of 'ownership' the hybrid transfer definition would apply, even if Country A treated B Co as the legal owner of the shares in B Sub, provided Country A continued to tax A Co on its beneficial ownership of the cash-flows from those shares.
 - (ii) under the laws of Country B, B Co is the owner of the shares in B Sub and the rights of A Co are treated as obligations of B Co (the obligation to sell the shares back to A Co).
- (c) As the arrangement is a hybrid transfer any jurisdiction that grants relief for tax withheld at source on a payment made under the arrangement (e.g. withholding tax on the dividend) should restrict the tax credit in proportion to the net taxable income under the arrangement.
- (d) The effect of the hybrid mismatch rule would be to deny A Co a deduction for the payment made under the hybrid transfer to the extent such payment is not brought into account as ordinary income by the B Co under the laws of Country B.

112. If Country A were not to adopt the primary rule, Country B would force the inclusion of the payment to the extent a deduction was granted for those payments under the law of Country A.

5. Scope

A. *Hybrid financial instrument rule does not apply to payments that benefit from a dividend exemption.*

113. As indicated in Section 2 above, this Consultation Document recommends that jurisdictions that have a system which grants a tax exemption for dividend payments do not grant the benefit of that exemption for a payment that is deductible under the laws of the issuer's jurisdiction. This should have the effect of eliminating any mismatch in respect of this category of instruments so that they will not be subject to the hybrid financial instrument rule.

114. There are a number of reasons why it has not been considered necessary to limit the scope of this recommendation. Unlike other types of payments made under hybrid financial instruments, which may not be treated as income in the jurisdiction of receipt, the dividend exemption applies to payments that would be ordinarily included under the laws of the holder's jurisdiction. In the context of payments subject to a dividend exemption the mismatch is premised on the holder's claim for relief from double taxation. It seems appropriate from a tax policy perspective for a tax administration to require the holder to prove that they are eligible for that exemption and it does not seem appropriate to impose a restriction on such a requirement under a hybrid financial instrument rule.

115. Furthermore the taxpayer compliance and tax administration issues seem more manageable in the context of dividend exemptions than they do in relation to other types of mismatches. In particular it is not unusual for information about the tax treatment of a dividend to flow from the issuer to the holder at or around the time of payment. Accordingly this Consultation Document recommends that those countries with dividend exemption regimes should be able to deny the benefit of the exemption for such deductible payments without any qualification as to scope.

B. *Overall approach to scope*

116. In light of the primary recommendation, the focus of the hybrid financial instrument rule is on payments made under hybrid financial instruments that produce D/NI outcomes that are unconnected to a dividend exemption. The primary targets of the hybrid financial instrument rule are convertible notes and other structured debt products where the mismatches are typically the product of technical differences in the way jurisdictions tax debt instruments rather than differences in the way the instrument as a whole is characterised. As such, these mismatches may, in practice, be more difficult for taxpayers and tax administrations to identify and eliminate.

117. The appropriate scope of the hybrid financial instrument rule involves questions of tax policy (i.e. what kind of arrangements ought to be captured by the rule) and questions of tax administration (i.e. can the rule be applied and enforced). These concerns are to a certain degree complementary and overlapping in that an overly broad hybrid mismatch rule that captures arrangements outside the intended policy will be more difficult to administer. Equally, a balance needs to be struck between a properly targeted rule and one that is clear and comprehensive. In particular the final report should not recommend a hybrid financial instrument rule that is overly complex or requires the taxpayer or tax administration to make difficult or qualitative judgements as to whether the instrument falls within the scope of the rule.

118. There are currently two approaches being considered in defining the scope of the hybrid financial instrument rule.

(a) *Defining what is included or a “bottom-up” approach*

119. One approach under consideration is a *bottom-up* approach. This approach seeks to identify and define those transactions which raise the most significant concerns from a tax policy perspective. Specifically this approach would scope in instruments held by related parties (including persons acting in concert) and any instrument that was part of a “structured” arrangement deliberately designed to produce a mismatch (using a test with objectively measurable criteria). While such an approach runs the risk of being less comprehensive, it should result in a more targeted rule that would address many of the compliance concerns by excluding unintended or accidental mismatches from the scope of the rule.

(b) *Defining what is excluded or a “top-down” approach*

120. The other approach being considered is a *top-down* approach. It would start with a broad hybrid financial instrument rule that applies to all hybrid mismatches other than those that fall within certain defined exceptions where it would be impossible or unduly burdensome for the taxpayer to comply with the rule. Because the specific compliance costs and risks presented by the hybrid financial instrument rule depend on the nature of the arrangement and the role played by the taxpayer under that arrangement, this approach would permit different carve outs for different taxpayers in respect of different instruments. Such an approach would have the advantage of being comprehensive in that it need only exclude arrangements where there was a clear case for doing so.

(c) *Similar overall outcome*

121. Ultimately the difference between a top-down or bottom-up approach may not produce a significant difference in terms of outcome or mechanics. In particular, regardless of how the scope of the rule is articulated, as a matter of substance, the hybrid financial instrument rule should:

- (a) apply to instruments held by related parties (including persons acting in concert);
- (b) apply to any hybrid financial instrument that is part of a structured arrangement designed to produce a mismatch; and
- (c) generally not apply to the issuer of a widely-held instrument (subject to any necessary qualifications in relation to related parties and structured arrangements).

122. The hybrid financial instrument rule should apply to all instruments held by related parties (including persons acting in concert) regardless of whether the instrument is widely held. Thus, regardless of what approach is taken it would not be possible for related parties to avoid the application of the hybrid mismatch rule by structuring an arrangement that falls within the exception for widely-held instruments. Furthermore it would be necessary to consider a further limitation to the exception that would apply if the taxpayer is nevertheless a party to a structured arrangement that has been deliberately designed to engineer a mismatch between the holder and the issuer.

123. The top-down approach therefore contains elements of the bottom-up approach because there will be certain arrangements (such as related party and structured arrangements) that need to be defined. Concerns about a bottom-up approach are therefore more directed at the difficulties in applying these tests to a broad range of arrangements and whether it is appropriate to exclude, by default, a wide category of instruments from the application of the rule rather than focussing on more

targeted exclusions under a top-down approach. Concerns about the top-down approach are the same, but in reverse, that is to say; whether it is appropriate to scope in such a broad range of low-risk arrangements and whether it is possible to produce a comprehensive list of targeted exclusions while still retaining a workable rule.

124. Parts C and D below set out the implications of these different approaches in more detail by reference to some practical examples.

C. Definition and application of the bottom-up approach

125. Under this approach the hybrid financial instrument rule would apply to all instrument held between related parties (including persons acting in concert) and hybrid financial instruments entered into as part of a “structured” arrangement.

(a) Related parties (including persons acting in concert)

126. Regardless of whether a bottom-up or top-down approach is taken to defining the scope of the hybrid financial instrument rule, this Consultation Document recommends that the rule should apply to any mismatch that arises between related parties (including persons acting in concert). In practice it is expected that hybrid mismatches between such parties will be intended and, even in those cases where the mismatch arose by accident rather than design, parties that share a significant degree of common ownership or control can be expected to identify and negotiate an appropriate allocation of risk in relation to the application of the hybrid mismatch rule.

127. For these purposes, the test for related party status can be set with a relatively low threshold. Companies, funds and other entities and arrangements can generally be expected to take into account the position of their non-portfolio investors (i.e. 10% or greater) when entering into their arrangements with those investors. Similarly any non-portfolio investor should, in general, have a sufficient economic stake in the issuer to obtain the information necessary to comply with the hybrid mismatch rule.

128. The related party test also includes relationships outside the ownership context where the parties have a material interest in engineering a particular tax outcome and there are coordination mechanisms in place that allow them to undertake collective action (i.e. acting in concert). Parties that have entered into shareholders or voting agreements, joint ventures and private equity funds under the control of a common manager all raise relationship issues that are similar to those presented by related parties and should therefore be treated in a similar manner. A draft of a related party rule and a rule for determining whether persons are acting in concert is set out in the boxes below.

Related Persons

Two persons are related if the first person has a 10% or greater investment in the second person or there is a third person that holds a 10% or greater investment in both.

A person will be treated as holding a 10% investment in another person if that person holds directly, or indirectly through an investment in other persons, 10% of:

- a) the voting rights of that person; or
- b) the value of any equity interests of that person.

Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.

Equity interests means any interest in a person that includes an entitlement to profits or eligibility to participate in distributions.

Acting in Concert

For the purposes of the related party rules a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person.

Two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:

- a) they are members of the same family;
- b) one person regularly acts in accordance with the wishes of the other person in respect of ownership or control of such rights or interests;
- c) they have entered into an arrangement in respect of ownership or control of any such rights or interests; or
- d) the ownership or control of any such rights or interests are managed by the same person or group of persons.

129. The above definitions would need to be refined in accordance with local law while staying within the framework of the principles stated above. For example many jurisdictions will already apply related persons tests that include family members and groups of persons and these concepts can be assimilated into the above tests.

130. The definition of related party needs to be further refined under local law in order to deal with non-standard investment vehicles such as trusts, foundations and unincorporated bodies. Applying the 10% related party threshold can be complicated by the decision-making and ownership structure of such entities or arrangements, however, in general, a related person should be anyone with powers to appoint persons to manage and control the entity or arrangement or with entitlement to, or powers to control, any distributions from the entity or arrangement. A draft setting out the application of the related party rule to non-standard investment vehicles is set out in the box below.

Non-standard Investment Vehicles

For the purposes of the related party rules "person" includes any entity or unincorporated body of persons (and includes a trust) and, in relation to any person:

- a) *constitution* means the rules governing the relationship between the person and its owners and includes articles of association or incorporation.
- b) *director* means any person who has the power under the constitution to manage and control that person and includes a trustee;
- c) *distribution* means a payment of profits or gains by that person to any owner;
- d) *owner* means anyone with an entitlement (whether contingent or not) to the profits of that person, or to participate in a distribution from, that person.

(b) *Structured arrangements*

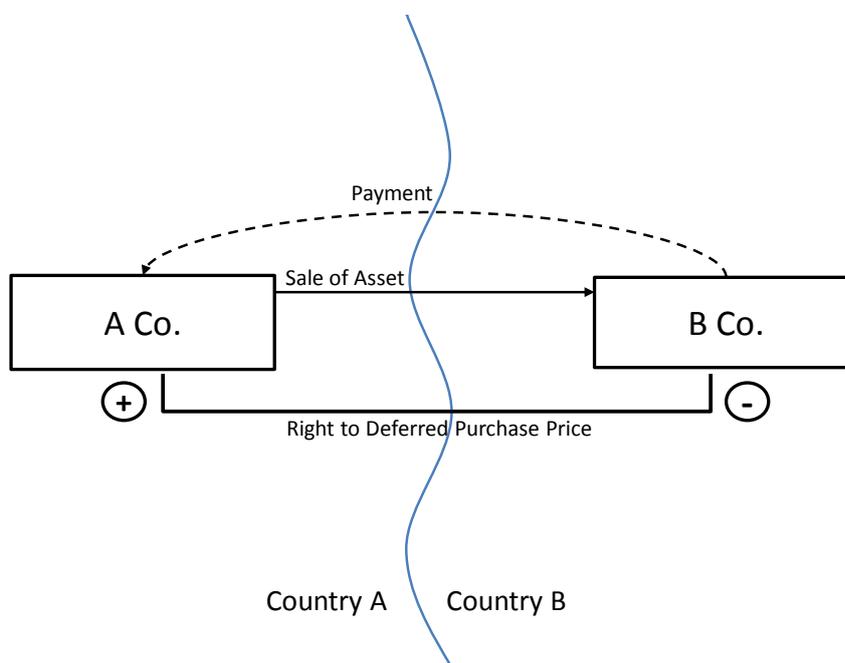
131. The hybrid financial instrument rule would also apply to all hybrid financial instruments entered into as part of a structured arrangement. This approach would test for such an arrangement by compiling a list of readily identifiable factors that indicated whether it was likely to have been engineered to produce a mismatch in tax outcomes. Such indicators could include:

- (a) an arrangement which was developed to exploit differences in the tax treatment; marketed as a tax-advantaged product or marketed to investors that would benefit from the tax arbitrage;
- (b) the pricing of the arrangement took into account sharing of the tax benefit or the expected tax benefit of a hybrid mismatch;
- (c) the tax benefits are significant in proportion to the non-tax business and financial consequences of the arrangement;
- (d) the arrangement involves features indicative of tax-motivated structured products, such as tax-indifferent accommodation parties or special-purpose vehicles;
- (e) there are collateral arrangements or terms embedded in the instrument that alter the economic return under the instrument in the event that the tax benefit is no longer available.

132. The list of indicators for a structured arrangement is being further explored. The challenge in this approach is identifying objective, readily identifiable features of an arrangement that comprehensively target arrangements that are undertaken by otherwise unconnected parties that are designed to produce a mismatch. This approach also necessitates a more detailed examination of the circumstances of each arrangement and an identification of factors which may not be evident from the terms of the transaction documents themselves.

133. The following example illustrates the application of a bottom-up approach to a structured arrangement. While the arrangement described below is not the kind of arrangement that is the primary focus of the hybrid financial instrument rule, the example illustrates the kind of arrangements the rule would capture and some of the challenges in defining the scope.

Figure 5. Basic Hybrid Financial Instrument Structure



134. In this example A Co (a company resident in Country A) arranges for the sale of an asset to B Co (a company resident in Country B) with the purchase price payable over 24 months. Under

Country B law the difference between the book value of the asset on acquisition and the total price paid is treated as interest under a debt instrument. Under Country A law, the consideration for the sale of the asset is excluded from income (e.g. it is treated as a tax free capital gain). By attributing a low book value to the asset the parties can engineer a mismatch in tax outcomes.

135. The arrangement entered into between A Co and B Co is not a standard lending arrangement and, under Country A law is not regarded as a lending arrangement at all. The hybrid financial instrument rule applies however because of particular quirks in the way Country B goes about defining and taxing debt instruments. Because the mismatch is of a technical nature it may be one that the parties did not anticipate when the agreement was originally negotiated. Equally, however, the sale and purchase transaction could have been deliberately structured in order to exploit the difference in tax treatment.

136. Part of the challenge in defining the appropriate scope of the hybrid financial instrument involves a determination of whether it is possible to distinguish between unintended or deliberate mismatches in relation to such transactions and whether it is appropriate or necessary to require information to be exchanged between the parties to the mismatch. Applying a definition of "structured arrangement" it might be possible to show, for example, that the pricing of the arrangement took into account the tax benefit of the mismatch or that the terms of sale or pre-sale structuring contained features that indicated the arrangement had been developed to exploit the resulting differences in tax treatment.

137. The bottom-up approach of scoping-in targeted arrangements ensures that the rule only applies when the parties know or ought to know of the mismatch. While such an approach runs the risk of producing a rule that is less comprehensive, it would address some of the compliance concerns raised by the application of the hybrid financial instrument rule by excluding accidental mismatches from the scope of the rule.

138. A comparison of the advantages and disadvantages of this approach are summarised below.

(a) Advantages:

- (i) the approach is more tightly focused;
- (ii) the approach minimises the information requirements and number of compliance concerns (see discussion below for ordinary lending arrangements between unrelated parties, widely-held instruments and traded instruments);
- (iii) there is no need to define widely-held and traded instruments.

(b) Disadvantages:

- (i) the approach may be less comprehensive;
- (ii) clear definitions of related parties, parties acting together and structured arrangements are required in order to apply the rule;
- (iii) the list of bright-line factors for structured arrangements could be circumvented if no clear general principles are provided.

D. Definition and application of top-down approach

139. The *top-down* approach would start with a broad hybrid financial instrument rule that applies to all hybrid mismatches. The top-down approach would then need to exclude categories of arrangements (for example when it might be unduly burdensome for the taxpayer to comply with the rule). In summary, this approach can be divided into three logical steps:

- (a) Scope: all inclusive (no distinctions between related, unrelated, acting in concert and structured arrangements);
- (b) Exceptions: for example in situations where it would be unduly burdensome for the taxpayer to comply with the rule (e.g. widely-held);
- (c) Those exceptions will not apply if arrangements are entered into between related parties/acting in concert or are structured arrangements.

140. The advantages and disadvantages of this approach are summarised below:

(a) Advantages:

- (i) the top-down approach would have the advantage of being comprehensive in that it would only exclude arrangements where there was a clear case for doing so and, depending on the jurisdiction, may effectively impose the burden of proof on taxpayers to prove out of the rule.
- (ii) no definitions are required in order for taxpayers and tax administrations to apply the basic rules (step (a) above), as opposed to the bottom-up approach where clear definitions of related parties acting in concert and structured arrangements are required (although it should be noted that definitions are required under this approach as well in dealing with steps (b) and (c) above).
- (iii) the approach would offer flexibility as it would be possible to identify factors or cases that should be carved out (e. g. in cases where it could be unduly burdensome for the taxpayer to comply).
- (iv) the rules are based on the general principle that realizing tax advantages from hybrid mismatch arrangements falling within the scope of the rule are not permitted from a tax policy perspective. This may assist with the interpretation of a structured arrangements test.
- (v) the approach would be consistent with certain design principles set out at Part II, Section 2 of this Consultation Document (e. g. the top-down approach would allow rules to apply automatically in certain cases).

(b) Disadvantages:

- (i) this approach would introduce a number of compliance concerns and information requirements (see discussion below for ordinary lending arrangements between unrelated parties, widely-held instruments and traded instruments).
- (ii) definitions for widely-held instruments would be required and could be manipulated.

- (iii) in common with the bottom-up approach, clear definitions of related parties, parties acting together and structured arrangements are required in order to recapture arrangements falling within step 3 above.

(c) *Application to ordinary lending transactions between unrelated parties*

141. One challenge in formulating a top-down approach is that it brings in a number of ordinary lending arrangements that may present little risk from a hybrid mismatch perspective.

142. The hybrid financial instrument rules pick up differences in the way payments made under the instrument are taxed under the laws of the holder's and issuer's jurisdiction. They are not directed at timing differences or currency fluctuations. Accordingly, most ordinary lending arrangements are unlikely to lead to the kinds of mismatches targeted by the hybrid financial instrument rule. The hybrid mismatch rule could apply, however, to any debt instrument that is held cross-border (whether on initial issuance or following a transfer). Thus, while most ordinary lending arrangements are unlikely to give rise to the kind of mismatch that the rule is designed to cover, the hybrid financial instrument rule will nevertheless impose compliance obligations on every person who is a party to an instrument unless those instruments are carved out of scope. This is because any debt instrument that is held cross-border (whether on initial issuance or due to a subsequent transfer) has the potential to produce a mismatch in tax outcomes that would bring it within the scope of the rule.

143. It may be possible to address some of these compliance concerns by incorporating information exchange requirements into the loan instrument itself. For example, the issuer could be required to communicate to the payee, whenever a payment is made, to what extent that payment was deductible. This would involve an information exchange mechanism that does not currently exist for many loan arrangements and, may not be practical or effective in the case of accruals where there is no corresponding cash payment. It is also not clear to what extent the holder can or should, be able to rely on information provided by the issuer, who will typically be located in a different jurisdiction from the holder.

144. The most reliable way for a holder or issuer to comply with the hybrid financial instrument rule would be to obtain foreign tax advice on the treatment of the instrument in the counterparty jurisdiction. The advice required may, however, contain a significant amount of technical detail. In order to ensure the mismatch was not merely attributable to differences in timing, the issuer or holder would need advice comparing the foreign and domestic tax treatment of all cash flows over the life of the arrangement (adjusted to eliminate foreign currency effects).

145. To reduce compliance costs the top-down approach could exclude certain categories of instruments that posed a low or nil risk from a hybrid mismatch perspective. These exclusions could be based on the terms of the instrument (e.g. plain vanilla loans at a market rate of interest), the nature of the counterparty (e.g. loans made to individuals) or the circumstances in which they were entered into (e.g. at retail). Such an approach could incorporate bright-line safe harbours, however the list of exceptions to the rule may make it more technical and less clear and transparent in its operation.

(d) *Widely-held or traded*

146. Similarly the top-down approach would need to address the treatment of widely-held and traded instruments. The hybrid element in a hybrid financial instrument is a product of the arrangement between the parties rather than the tax character of the parties to the arrangement. Accordingly the same relationship can be replicated with a number of different parties (i.e. hybrid financial instruments can be widely-held) and can be transferred from one party to another (i.e. they can be traded). These

two features of hybrid financial instruments pose additional challenges and risks in framing the proper scope of the rule using a top-down approach.

(i) Issuers of widely-held instruments

147. This Consultation Document recommends that the hybrid financial instrument rule should not be applied to an issuer of an instrument that is “widely-held”. A widely-held instrument is one that is held by a large number of holders across a number of jurisdictions and it would include a widely-held and regularly traded bond. Any test for widely-held would need to account for instruments held through custodians and other arrangements where it may be difficult for the issuer to determine who holds the instrument and in what proportions.

148. An instrument that is widely-held will typically be offered to the public, will have market standard terms and conditions and will provide holders with a market rate of return. The fact that the same instrument is widely-held by different taxpayers across a number of jurisdictions makes it more difficult for the issuer to apply the rule or to deliberately engineer a hybrid mismatch. An issuer of a widely-held instrument may have little, if any, control over who the holder will be and it may not be practical to expect the issuer to collect the necessary information and make the tax calculations required to comply with the hybrid mismatch rule.

149. As noted above, any exception for widely-held instruments should not apply to related parties. In addition it would be necessary to have a further limitation to the exception to capture structured arrangements that had been deliberately designed to engineer a mismatch between the holder and the issuer. A number of bright-line tests could be applied to determine whether the instrument is issued or held as part of a structured arrangement including: the existence of materials marketing the arrangement as a tax advantaged transaction; or collateral arrangements or terms embedded in the instrument that alter the economic return under the instrument in the event that the tax benefit is no longer available.

(ii) Holders of widely-held instruments

150. An issue that needs to be explored further under the top-down approach is whether the exemption for widely-held instruments should be limited to issuers so that holders would still be required to include a deductible payment in income even if the issuer benefitted from the widely-held exemption.

151. The tax policy concerns that apply to issuers of widely-held instruments do not necessarily apply to the holders of such instruments: a holder may acquire a widely-held hybrid financial instrument to secure the benefit of the mismatch and, depending on the nature of the instrument and the rules governing deductibility in the issuer’s jurisdiction, the absence of a *one to many* relationship from the holders standpoint may mean that it is not unduly burdensome for the holder to obtain the information necessary to calculate the results under the hybrid mismatch rule.

152. Imposing a hybrid mismatch rule on the holder of a widely-held instrument would, however, ultimately result in the imposition of tax compliance obligations for both the holder and issuer. There would need to be a mechanism that allowed for the issuer to communicate information to the holder about the tax treatment of the instrument under the laws of the issuer’s jurisdiction and it would likely be incumbent on the holder to obtain further tax advice on differences between foreign and domestic law treatment in order to comply with the hybrid mismatch rule. Currently there are no mechanisms for reporting this information to holders. Imposing this type of obligation on holders and issuers may be costly and resource intensive and would be an obligation that was imposed on all instruments

regardless of whether they contained a hybrid element. As indicated in the comments below in relation to traded instruments, an information system that is based on matching the tax treatment of holders and issuers would be extremely challenging to implement on a multi-jurisdictional and integrated basis.

(iii) Traded instruments

153. The fact that an instrument has been transferred means that the issuer no longer has control over the identity of the new holder and may no longer have the ability to obtain the necessary information to comply with the rule. This suggests that it may be more difficult to apply the hybrid mismatch rule to traded instruments.

154. While the holder is perhaps in a better position to protect itself from the potential application of the hybrid mismatch rule than the issuer, a holder may face a number of challenges in obtaining the information necessary to make an informed decision about the potential application of the hybrid mismatch rule. This is particularly the case outside of the widely-held context where the issuer may not maintain a prospectus or any other publicly available document which could assist a potential holder in determining its likely tax position under the instrument prior to purchase.

155. There are unlikely to be representations or warranties in the loan document itself that would assist the holder in making this determination (particularly if the loan was originally entered into between taxpayers that were resident in the same jurisdiction). Any representation or warranty that is given (such as what percentage of payments under the loan will be deducted) will be out of date, as it will only be given as at the time the loan was entered into, not when the holder acquires the loan. Such information, in any event, may be insufficient to allow the holder to be able to reliably and accurately calculate its liability under the hybrid mismatch rule.

156. These difficulties may be hard to address even if new disclosure obligations were imposed on the issuer as part of the BEPS work. Such obligations need to be imposed on all issuers in relation to all financial instruments (as any potential hybrid effect would not be known at the time of issuance) and would only apply for the benefit of the holder in another jurisdiction. Disclosure of the issuer's tax treatment would need to be continuously updated for any potential holder; communicated to the world at large; and applied to instruments already on issue (unless such arrangements were to be grandfathered from the scope of the rule).

157. There are concerns, however, that a general exception for traded instruments would make the hybrid financial instrument rule 'static' and open to abuse through structured arrangements. Taxpayers could enter into financial instruments that did not give rise to a mismatch in tax outcomes on initial issuance but were subsequently transferred to a holder in order to take advantage of their hybrid character. Any exception for traded instruments would therefore need to be limited so as to exclude those cases where the transfer is to a related party or the transfer is part of a structured arrangement designed to engineer a hybrid mismatch.

E. Hybrid regulatory capital

158. One further scoping issue concerns the treatment of hybrid regulatory capital. There is widespread recognition of the need for financial institutions to be appropriately capitalised and properly regulated. Under Basel 3, a proportion of the capital that banks are required to hold (against both nominal and risk-weighted assets) can be met through Additional Tier One (AT1) capital. These instruments are required by the regulatory rules and have both debt and equity-like features; making regular remuneration payments but being subordinated, perpetual and automatically convertible to ordinary shares in periods of stress.

159. Given the hybrid features of AT1, countries have chosen to adopt different positions with respect to its taxation. Some countries (including the United Kingdom) have interpreted AT1 as debt, with remuneration payments typically deductible at the level of the issuer and taxable at the level of the recipient. Other countries (including the United States) treat AT1 as equity, with remuneration payments typically non-deductible at the level of the issuer but either non-taxable or subject to a lower rate of tax at the level of the recipient. These differences in treatment create the possibility of mismatches in cross-border AT1 transactions.

160. It is assumed for the purposes of discussion that AT1 instruments issued directly to the market are unlikely to be caught by either a related-party hybrid mismatch rule, or a more widely drafted rule that contains a specific carve out for ‘widely-held’ or ‘traded’ instruments. However, as a result of regulatory requirements, banks are increasingly constrained in their ability to raise capital in this way. As part of a wider move towards a ‘single point of entry’ resolution, a number of regulators are encouraging banking groups domiciled in their jurisdiction to issue all their loss absorbing capital at top holding company level and then pass this capital down through the group to the relevant operating subsidiaries. For example, where a UK subsidiary of a US bank needs to raise AT1 capital, it would be required to issue an AT1 instrument to its parent, which is then paid for (directly or indirectly) through excess funds or a market issuance at top holding company level. These arrangements may also be motivated by the fact that regulatory capital issued directly to the market at subsidiary level may, in certain situations, be discounted or disregarded for consolidated regulatory capital purposes.

161. This means that, alongside an increase in the issuance of AT1 as a consequence of Basel 3, there are likely to be an increasing number of these instruments issued intra-group to adhere to emerging regulatory practices (even if the funding for these instruments is ultimately raised from the top holding company through unrelated investors).

162. Questions as to scope should therefore include consideration as to the appropriate treatment of hybrid financial instruments that are held by reason of regulatory requirement. As part of this, the case for a co-ordination rule which allows the tax effect of the issuer’s deduction to be passed down through chains of related parties to the ultimate borrower could be considered.

Box 2. Questions for Consultation

1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?
2. Is the outcome of the rules' operation clear?
3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?
4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?
 - (a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?
5. This part includes a number of examples: -
 - (a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?
 - (b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?
 - (c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments?
 - (d) Are there any other situations or examples, not covered here, that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?
6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).
7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements?
8. In relation to regulatory capital
 - (a) What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?
 - (b) Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?
 - (c) Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?

V. HYBRID ENTITY PAYMENTS

1. Description of the Hybrid Mismatch Arrangement

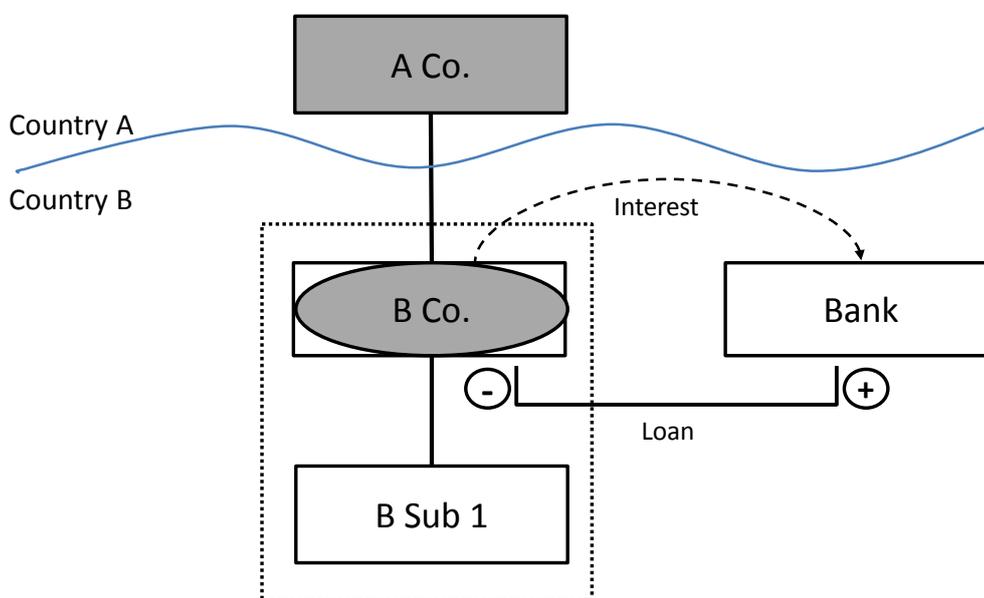
163. The second hybrid technique considered in this Part involves exploiting differences in the treatment of an entity or arrangement across two jurisdictions to produce DD or D/NI outcomes from payments made by that entity.

A. Double deduction techniques

(a) Basic double deduction structure

164. The most common double deduction hybrid technique involves the use of a hybrid subsidiary that is treated as transparent under the laws of the investor's tax jurisdiction and opaque under the laws of the jurisdiction where it is established or operates. This hybrid treatment can result in the same item of expenditure incurred by the hybrid being deductible under the laws of both the investor and subsidiary jurisdictions. The example below, taken from the Hybrids Report, illustrates a simple arrangement utilising this technique.

Figure 6. Basic Double Deduction Structure Using Hybrid Entity



165. In this example, A Co holds all the shares of a foreign subsidiary (B Co). B Co is a hybrid entity that is disregarded for Country A tax purposes. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is disregarded, A Co is treated as the borrower under the loan for the purposes of Country A's tax laws. The arrangement therefore gives rise to an

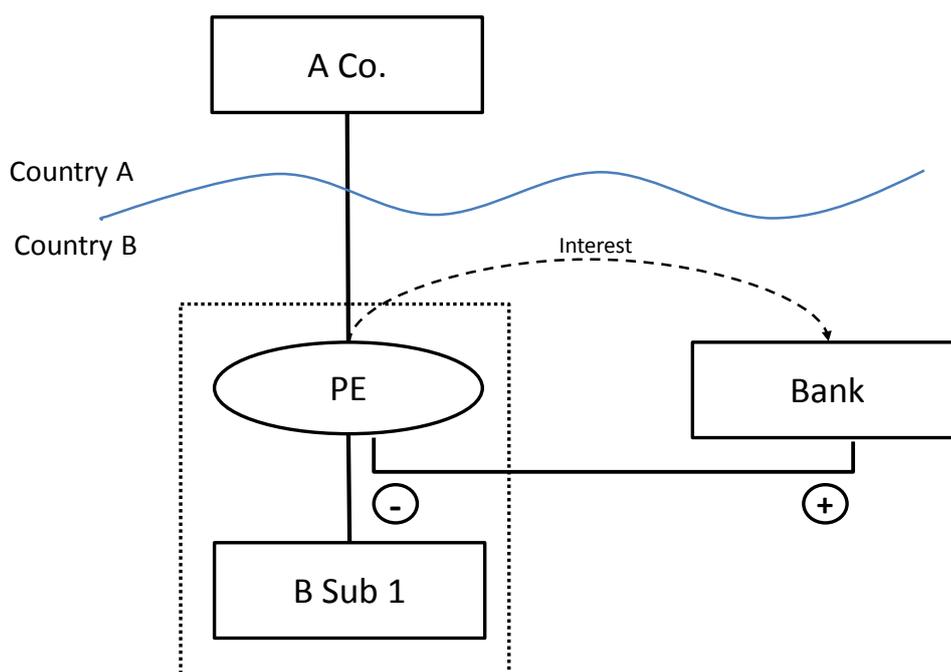
interest deduction under the laws of both Country B and Country A. B Co is consolidated, for tax purposes, with its operating subsidiary B Sub 1 which allows it to surrender the tax benefit of the interest deduction to B Sub 1. The ability to “surrender” the tax benefit through the consolidation regime allows the two deductions for the interest expense to be set-off against separate income arising in Country A and Country B.

(b) *Use of other structures*

166. While the basic example illustrated above involves a wholly-owned and disregarded subsidiary the same double deduction outcome can be achieved using a partially-owned hybrid entity that is treated as a partnership for tax purposes in the investor jurisdiction. In such a case, however, the duplicate deduction claimed in the investor’s jurisdiction would be proportionate to the investment in the hybrid entity. This example is discussed further in the technical discussion in Part VII of the Consultation Document.

167. Similarly the same structure can be used without involving a hybrid entity provided the subsidiary jurisdiction allows permanent establishments to consolidate for tax purposes with other resident companies. The example below illustrates such a structure.

Figure 7. Basic Double Deduction Structure Using a Permanent Establishment



168. This structure is the same as the structure illustrated in Figure 6 above except that A Co maintains a permanent establishment in Country B which is consolidated with B Sub 1. The interest expenditure incurred through the permanent establishment is a deductible expenditure under the laws of both Country A and Country B. The consolidation regime in Country B allows the permanent establishment to “surrender” the tax benefit of the deduction to B Sub 1 meaning that the same interest expense can be set-off against separate income arising in Country A and Country B.

169. In isolation, the double deduction may not be objectionable from a tax policy standpoint. Allowing a deduction in both jurisdictions is the orthodox response where Country A taxes the worldwide income of its residents, including the income derived through the activities of a permanent establishment or transparent entity located in a foreign jurisdiction. In this case the deductible expense must be recognised in both jurisdictions in order to offset the double income inclusion (i.e. income which is taxable under the laws of both jurisdictions). The DD outcome only raises base erosion issues when it is eligible to be set-off against income that is not subject to tax in the other jurisdiction. This effect can be demonstrated by assuming, in the above example, that B Co (or the PE) derives no income. In such a case the interest expense that is deemed to arise in Country A might then be set-off against A Co's in-country income, thus reducing the amount of tax payable under Country A law.

170. In certain cases the reduction in Country A's tax base may only be temporary (i.e. it will be reversed out in a subsequent taxable period). This would be the case, under the example illustrated above, if the PE or B Co was not consolidated with any other taxpayer in Country B so that any net loss in the first taxable period was required to be carried forward into a subsequent period under Country B law to offset future income. The effect of the loss carry-forward would then be to reduce the amount of Country B tax in the future period and therefore the tax credits available to shelter A Co's Country A tax liability on the same income. Under ordinary operating conditions the net effect of this arrangement over time should therefore be neutral under both Country A and Country B law as the reduction in tax payable in Country A in the first period would be offset by an increase in Country A tax in a future period.

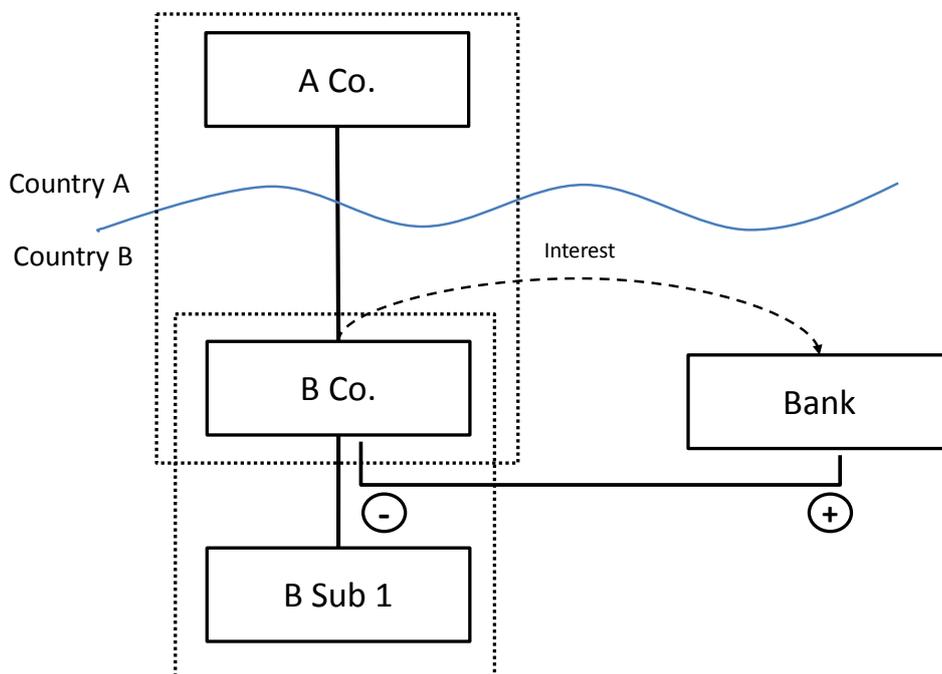
171. While in theory double deduction structures can be unobjectionable from a tax policy standpoint, in practice they give rise to tax policy concerns, particularly from the perspective of the investor jurisdiction:

- (a) The hybrid entity is usually structured so that it never generates a net profit, this ensures that there is never sufficient dual inclusion income to eliminate the mismatch generated by the duplicate deduction.
- (b) In the event the hybrid entity does begin to generate surplus dual inclusion income, the investor can simply restructure its holding in the hybrid entity to prevent the surplus income from being included under the laws of the investor jurisdiction.
- (c) The loss surrender mechanism in the subsidiary jurisdiction can be used to make the mismatch in tax outcomes permanent. The surrendering of surplus deductions to non-hybrid entities means that the deduction will no longer be available to reduce any dual inclusion income that may be derived by the hybrid entity in the current or any subsequent period. Thus any dual inclusion income derived by the hybrid in a subsequent period will be subject to tax under the laws of the subsidiary jurisdiction (Country B in the above examples) at the full rate and such tax will be fully creditable under the laws of the investor jurisdiction (Country A in the above examples). The effect of the loss surrender under the consolidation regime therefore allows for each deduction to be set-off permanently against "other income" permanently eroding the tax base of the investor jurisdiction.

(c) *Dual residents*

172. As illustrated in Figure 7 and highlighted in the discussion above the central mechanic that gives rise to the base erosion and profit shifting outcome is the ability to surrender the duplicate deduction in one jurisdiction to another entity that does not derive any dual inclusion income. Accordingly a similar hybrid effect can be achieved by orchestrating a structure where the entity, while not hybrid, is a member of more than one tax consolidation group. The example below illustrates how the same kind of mismatch can be engineered through such dual consolidation structures.

Figure 8. Dual Consolidated Companies



173. In the example illustrated in Figure 8 above, A Co (a company incorporated and tax resident in Country A) holds all the shares in B Co (a company incorporated in Country B but tax resident in both Country A and Country B). B Co owns all the shares in B Sub 1 (a company tax resident and incorporated in Country B). B Co is consolidated, for tax purposes, with both A Co (under Country A law) and B Sub 1 (under B Country Law).

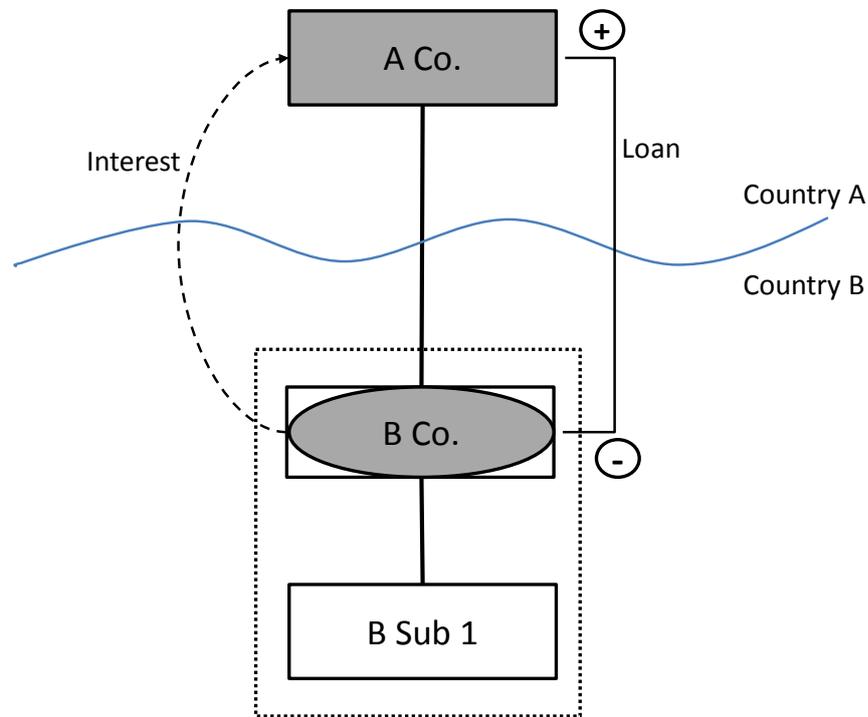
174. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is resident in both Country A and Country B it is subject to tax on its worldwide income in both jurisdictions on a net basis and can surrender any net loss under the tax consolidation regimes of both countries to other resident companies. The ability to “surrender” the tax benefit through the consolidation regime in both countries allows the two deductions for the interest expense to be set-off against separate income arising in Country A and Country B.

B. Deduction / no inclusion techniques

(a) Basic D/NI structure

175. The same basic hybrid technique can also be used to engineer D/NI outcomes. The most basic structure involves a payment made by a hybrid entity to its investor that is deductible under the laws of the payer’s jurisdiction but disregarded under the laws of the investor jurisdiction. This type of structure is illustrated below:

Figure 9. Disregarded Payments Made by a Hybrid Entity to a Related Party



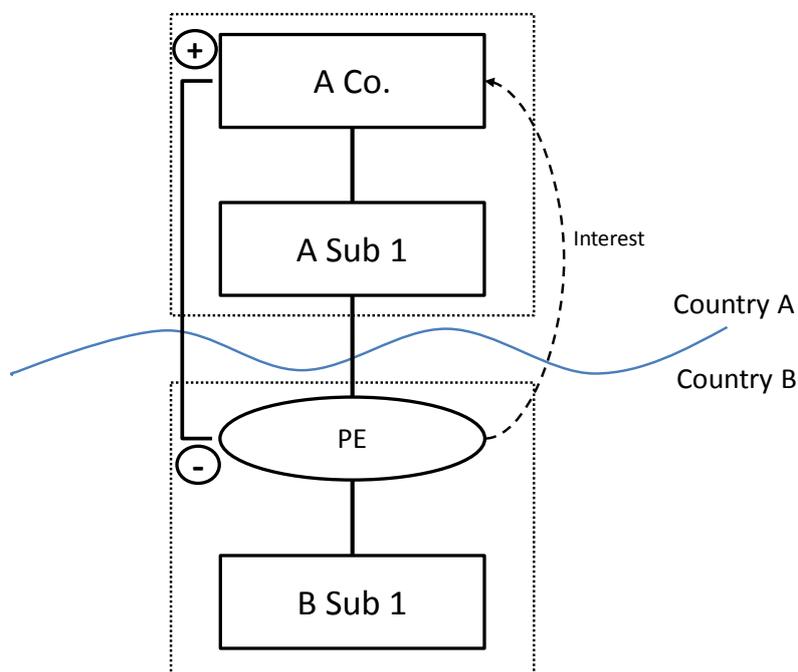
176. This structure is identical to the example outlined in Figure 6 except that, instead of borrowing from a bank, B Co borrows from A Co. B Co is treated as transparent under the laws of Country A and (because A Co is the only shareholder in B Co) Country A simply disregards the separate existence of B Co. Disregarding B Co means that the loan (and by extension the interest on the loan) between A Co and B Co is ignored under the laws of Country A. In many cases, the funds lent from A Co to B Co are sourced from external borrowing by A Co (or an affiliate of A Co that either lends the funds to A Co or transfers funds to A Co in exchange for shares).

177. The arrangement therefore gives rise to an interest deduction under the laws of Country B but no corresponding inclusion under the laws of Country A. This deduction is then eligible to be offset against the income of B Sub 1 under the group consolidation regime. The ability to surrender the loss through the consolidation regime allows the deduction to be set-off against separate income arising under Country B law with similar effect to the DD structures described in Part A above. This technique can be used in only a relatively narrow category of arrangements because it generally relies on a payment being made by a hybrid entity to a related party in a different tax jurisdiction.

(b) Tax consolidation structures

178. In the case of D/NI structures discussed above, the technique used to generate the mismatch involves a hybrid. However, a similar hybrid effect can be achieved through the use of a tax consolidation. A payment made by an entity or arrangement to a person who is a member of the same tax consolidation group as the payee may be treated as deductible under the laws of the payer's jurisdiction without a corresponding inclusion under the laws of the payee's jurisdiction. This type of structure is illustrated in the example below:

Figure 10. Disregarded Payments Made by a Permanent Establishment



179. Under the example illustrated in Figure 10 above, A Sub 1 is a company incorporated and tax resident under the laws of Country A. A Sub 1 maintains a permanent establishment in Country B. A Sub 1 borrows money from A Co through a permanent establishment established in Country B. A Sub 1 and A Co are consolidated for tax purposes. The effect of the tax consolidation under Country A law is that all payments between members of a consolidated group are disregarded for tax purposes. Thus the interest payment made by the permanent establishment of A Sub 1 to A Co is deductible under the laws of Country B but not included under the laws of Country A. The deduction generated under Country B law is then applied against non-dual inclusion income through a group surrender under the laws of Country B.

2. Summary of Recommendations

180. As noted in the discussion above, hybrid payments that trigger duplicate deductions only raise base erosion and profit shifting issues when the deduction is permanently set-off against income which is not subject to tax in both jurisdictions (i.e. dual inclusion income). The most direct way of addressing this kind of hybrid mismatch would be, therefore, to prevent these deductions from being used against any income that was non-dual inclusion income in one jurisdiction. This, however, would entail parallel rules in both jurisdictions designed to restrict the use of the deduction in one or other of the jurisdictions. Such a rule would be complicated to apply because it would require taxpayers and tax administrations in one jurisdiction to have good information and understanding of the treatment of income and deductions under the laws of the other jurisdiction. Accordingly this Consultation Document recommends a simpler linking rule that only focuses on whether the payment gives rise to a deduction in the subsidiary jurisdiction that *could be* offset against dual inclusion income. The rule would also have a primary/secondary structure so that it would need to be applied only in one jurisdiction rather than both.

181. The DD rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid in the subsidiary jurisdiction (referred to as the "hybrid payment") and the corresponding "duplicate deduction" generated in the jurisdiction of the investor (see paragraph (a) of the recommendations below). The primary recommendation is that the duplicate deduction cannot be claimed in the investor jurisdiction to the extent it exceeds the claimant's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions) (see paragraph (d) below). A secondary or defensive rule applies to the hybrid in the subsidiary jurisdiction to prevent the hybrid claiming the benefit of a hybrid payment against non-dual inclusion income if the primary rule does not apply. In the case of both the primary and secondary rule excess deductions can be carried forward by a taxpayer and offset against future dual inclusion income. In order to prevent stranded losses, it is recommended that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction (see paragraphs (e) and (g) below).

182. The D/NI rule defines a disregarded payment as one that is made cross-border to a related party where the tax treatment of the payer results in the payment being disregarded under the laws of the payee jurisdiction (see paragraph (b) below). The deduction that is generated by a disregarded hybrid payment cannot exceed the taxpayer's dual inclusion income (see paragraph (f) below). As a secondary rule the payee would be required to include such excess deductions in income (see paragraph (h) below).

183. Recommendations for a linking rule eliminating mismatches through the use of hybrid entity payments are set out below.

Hybrid Payments

Meaning of hybrid payment, disregarded payment and dual inclusion income

- a) A payment will be a **hybrid payment** if it is deductible under the laws of a jurisdiction (the *subsidiary jurisdiction*) and that deduction may be set-off against non-dual inclusion income under the laws of the subsidiary jurisdiction and:
- the payer is not resident in the subsidiary jurisdiction and a duplicate deduction arises for that person (or a related person) under the laws of another jurisdiction; or
 - the payer is resident in the subsidiary jurisdiction but a duplicate deduction arises for an investor (or a person related to that investor) under the laws of another jurisdiction; or
 - the payer is resident in both the subsidiary jurisdiction and another jurisdiction.

In each case, the other jurisdiction is referred to in these recommendations as the *investor jurisdiction*.

- b) A payment will be a **disregarded payment** if it is deductible under the laws of a jurisdiction (the *payer jurisdiction*) and that deduction may be set-off against non-dual inclusion income under the laws of the payer jurisdiction and:
- the payment is to a related person that is a taxpayer in another jurisdiction (the *payee jurisdiction*); and
 - the treatment of the payer under the laws of the payee jurisdiction causes the payment to be disregarded under the laws of the payee jurisdiction.
- c) An amount shall be **dual inclusion income**:
- in respect of a hybrid payment, if it is brought into account for tax purposes under the laws of both the subsidiary and the investor jurisdiction.
 - in respect of a disregarded payment, if it is brought into account for tax purposes under the laws of both the payer and the payee jurisdiction

Payments that generate DD outcomes (deductible hybrid payments)

Primary rule

- d) The duplicate deduction that arises in the investor jurisdiction should be denied to the extent it exceeds the taxpayer's dual inclusion income for the same period. Any excess duplicate deduction can, however, be set-off against dual-inclusion income in a subsequent period.
- e) In order to prevent stranded losses, the excess duplicate deduction should be allowed in the investor jurisdiction, to the extent the taxpayer can establish, to the satisfaction of the tax administration, that the deduction for the hybrid payment cannot be set-off against the income of any person under the laws of the subsidiary jurisdiction.

Secondary rule

- f) In the event the above rule does not apply, the deduction for a hybrid payment should be denied in the subsidiary jurisdiction to the extent it exceeds a taxpayer's dual inclusion income for the same period. Any excess deduction can, however, be set-off against dual inclusion income in a subsequent period.
- g) In order to prevent stranded losses, the excess deduction for the hybrid payment should be allowed in the subsidiary jurisdiction, to the extent the taxpayer can establish, to the satisfaction of the tax administration, that the duplicate deduction cannot be set-off against the income of any person under the laws of the investor jurisdiction.

Payments that generate D/NI outcomes (disregarded hybrid payments)

Primary rule

- h) The deduction granted by the payer jurisdiction for a disregarded payment should not exceed a taxpayer's dual-inclusion income for the same period.

Secondary rule

- i) As a defensive measure the payee should be required to include, as ordinary income, in the payee jurisdiction, any disregarded payment to the extent the payer's deductions for such payment in the payer jurisdiction exceed the payer's dual inclusion income for the same period.

3. Technical Discussion

A. *Rule applies if deductible hybrid payment is eligible to be set-off against dual inclusion income*

184. Paragraph (d) will deny a duplicate deduction if the deductible expense incurred by the hybrid may be set-off against non-dual inclusion income. This will generally be the case where the jurisdiction permits the hybrid taxpayer to utilise the benefit of the deduction under a tax grouping regime. There are a number of mechanisms that countries use to achieve loss surrender within the confines of tax groups. Some countries permit taxpayers to transfer losses, deductions, income and gains to other taxpayers within the group. Other jurisdictions consolidate the group members so that they are treated as a single taxpayer. Other regimes permit deductible payments to be made intra-group that have the net economic effect of shifting taxable income within the group. The technique used to facilitate tax consolidation should not affect the outcome under these recommendations. Provided the effect of the consolidation regime would be to allow the hybrid taxpayer to offset the deductible payment against income that is not dual inclusion income the rule would apply.

185. For example, using the basic example of the double deduction structure illustrated at Figure 6, the interest deduction that arises under Country B law could be set-off against the income of B Sub 1 by making a deductible “loss surrender” payment to B Co that is treated as income under Country B law but is disregarded under Country A law. In this case the structure should still be regarded as giving rise to a hybrid mismatch arrangement because B Co’s deduction is eligible to be set-off against income that is not dual inclusion income.

B. *Deduction can be offset against any dual inclusion income*

186. Dual inclusion income, in the case of both deductible and disregarded hybrid payments, refers to any item of income that is taken into account under the laws of both jurisdictions where the mismatch has arisen. The effect of restricting the deduction to aggregate amount of a taxpayer’s dual inclusion income is that any excess deduction (i.e. any net loss incurred by the hybrid entity) is not available to be offset against any income that is taxable under the laws of only one jurisdiction. Limiting the deduction so that it can only be set off against dual inclusion income should eliminate the base erosion or profit shifting concerns associated with a double deduction.

187. To comply with the rule some jurisdictions may, for ease of administration, simply prevent the taxpayer from offsetting the deduction attributable to the hybrid payment against income that is not subject to tax in the other jurisdiction or from surrendering any net loss incurred by a hybrid entity to another group company. A more flexible approach, and one that would achieve better alignment in tax outcomes, would be to prevent the excess deduction from being surrendered if it would result in the loss being offset against any income that was not dual inclusion income. The hybrid mismatch rule is drafted so that the duplicate deduction can be claimed only against a certain type of income rather than only by a certain type of taxpayer. Thus the hybrid mismatch rule does not necessarily prevent a taxpayer from surrendering the deduction or loss to another company in the group, but such loss or deduction, once surrendered, could only be offset against income subject to tax under the laws of both jurisdictions.

C. *Rule order and impact on taxpayer’s ability to utilise losses*

188. Because the DD rule applies first to restrict the use of duplicate deductions the application of the primary rule in the investor jurisdiction should have the net effect of allowing the taxpayer in the

subsidiary jurisdiction to take advantage of the loss surrender mechanisms in that jurisdiction without any restriction.

189. In any situation, however, where the secondary rule applies, the entire deductible hybrid payment will be subject to restriction regardless of the amount of duplicate deduction that arises in the other jurisdiction. This has an implication for funds and other widely-held asset holding vehicles that are treated as entities under the laws where they are established but may be treated as transparent under the laws of the investor's jurisdiction. In particular, from a scope perspective, it may be unduly burdensome for such a hybrid entity to lose the full benefit of its deduction under the hybrid mismatch rule simply because a minority foreign investor has, without the consent or knowledge of the entity or fund, claimed a deduction for a portion of that expenditure under the laws of its own jurisdiction.

4. Application of the Rule

A. Double deduction structures

(a) Basic double deduction structure

190. The effect of implementing the recommendations under the laws of Country A on the example illustrated in Figure 6 would be as follows:

(a) The interest payment made by B Co is a *hybrid payment* as:

(i) a duplicate deduction arises for A Co under the laws of Country A (the investor jurisdiction); and

(ii) B Co can surrender the tax benefit of the interest deduction to B Sub 1 under the laws of Country B (the subsidiary jurisdiction) and hence the interest expense may be offset against non-dual inclusion income. The payment will be a hybrid payment even if B Co does not, in fact, set-off the deduction against the income of B Sub 1 under the tax consolidation regime in Country B. The linking rule does not require A Co or Country A to track how the hybrid payment has been applied under Country B law (although see the discussion of stranded losses in paragraph (c) below).

(b) The primary rule requires Country A to deny the duplicate deduction to the extent it exceeds A Co's dual inclusion income for the period. In the example illustrated in Figure 6, A Co does not derive any dual inclusion income. Therefore all of the interest deduction will be an excess deduction that is denied under the primary rule. In order to address mismatches that simply result in timing differences, the rule permits A Co to carry forward a denied deduction into a subsequent period to offset against future dual inclusion income.

(c) The primary rule also permits Country A to take steps to address stranded losses. These will arise when a duplicate deduction is denied in Country A but a corresponding deduction for a hybrid payment is not able to be set-off against income arising under the laws of Country B. Stranded losses could be addressed on a period by period basis (which would make the rule more difficult to apply) or could be addressed at the termination of the hybrid mismatch arrangement (e.g. on A Co's sale of its interest in B Co).

191. The effect of implementing the recommendations under the laws of Country B would be as follows:

- (a) If Country A applies the primary rule there is no need for the defensive rule to apply under the laws of Country B and the ordinary rules on loss-utilisation will apply.
- (b) If Country A does not apply the primary rule then Country B should deny B Co a deduction for the hybrid payment to the extent the deduction exceeds B Co's dual inclusion income in the same period. As with the primary rule, Country B should allow B Co to carry-forward such excess deduction into a subsequent period to offset against future dual inclusion income.
- (c) The primary rule also permits Country B to take steps to address stranded losses. These will arise when a deduction for the hybrid payment is denied in Country B but a corresponding duplicate deduction is not able to be set-off against income arising under the laws of Country A. As above, stranded losses could be addressed on a period by period basis or could be addressed at the termination of the hybrid mismatch arrangement (e.g. on A Co's sale of its interest in B Co).

(b) *Other structures*

192. The application of the rule to the examples illustrated in Figure 7 and 8 is the same. Figure 7 is an illustration of a hybrid mismatch using a non-resident hybrid and Figure 8 has an illustration of a hybrid mismatch using a dual resident hybrid. The only difference in the application of these rules is that, in the case of a dual resident hybrid, the payment is (for both Country A and B) a hybrid payment and therefore both Country A and Country B would apply the secondary rule, effectively ring-fencing any deduction to the dual resident entity (subject to the treatment of stranded losses under the rule).

B. Deduction / no inclusion structures

193. The effect of implementing the above recommendations on the D/NI structures illustrated at Figures 9 and 10 would be as follows:

- (a) the payment will be a *disregarded hybrid payment* because the payer is eligible to offset the deduction against non-dual inclusion income of another taxpayer under the laws of Country B and the payee (A Co) is a related party taxpayer in the payee jurisdiction that disregards the payment.
- (b) The deduction granted by Country B for the *disregarded hybrid payment* should not exceed the payer's dual inclusion income in the same period. The recommendation does not include a carry-forward of the excess deduction into the following period.
- (c) If Country B does not have a hybrid mismatch rule then, as a defensive measure, this Consultation Document suggests that A Co should include, as ordinary income, any excess deductions for such payment claimed and under the laws of Country B.

5. Scope

194. In common with other hybrid mismatch rules, the hybrid entity rule should cover mismatches that arise between related parties (with 10% ownership / control threshold including parties acting in concert) and structured arrangements.

195. A hybrid entity whose interests are widely-held, however, is unlikely to have sufficient information or control as to the identity and tax treatment of the counterparty to the mismatch. In such circumstances it might be impossible or unduly burdensome for such an entity to know that the mismatch has arisen or to comply with the hybrid mismatch rule. Accordingly widely-held hybrid entities should be excluded from the operation of the hybrid mismatch rules.

196. There does not appear to be any reason in practice or principle, however, why the degree of ownership or investment in the entity should limit the ability of the *investor* jurisdiction to apply the primary rule denying the investor the benefit of the loss for expenditure incurred through a hybrid entity. Given the investor has sufficient information about the income and expenses of the hybrid entity to claim the benefit of a net loss on its own return, it would also not appear to be unduly burdensome for the investor to comply with the hybrid mismatch rule in such circumstances.

Box 3. Questions for Consultation

1. Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?
2. Is the outcome of the rules' operation clear?
3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?
4. Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor?
5. If so when would these arise and what difficulties or constraints would the hybrid entity face?

VI. IMPORTED MISMATCHES AND REVERSE HYBRIDS

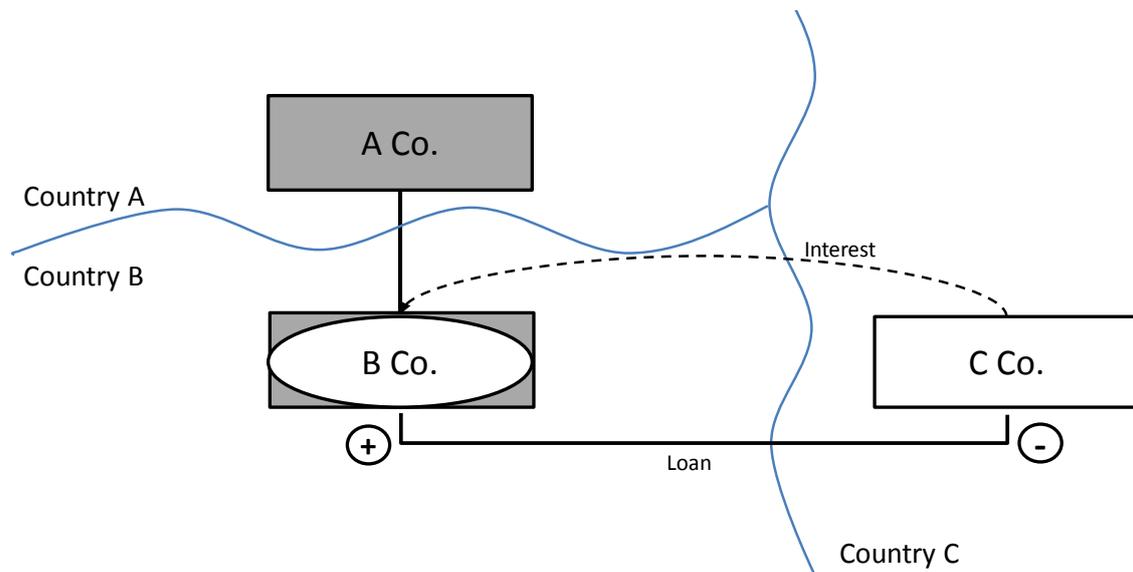
197. This part of the Consultation Document considers D/NI outcomes that arise through the use of imported mismatch structures including mismatches that arise from the use of reverse hybrids.

1. Description of the Hybrid Mismatch Structure

A. Basic imported mismatch using a reverse hybrid

198. Part V of this Consultation Document considered the tax implications of payments made by a hybrid entity. However mismatches in tax outcomes can also arise out of payments made to a hybrid. The hybrid in this case is usually described as a reverse hybrid because, in a reversal of the examples considered in Part V of this Consultation Document, the hybrid is treated as *opaque* by its foreign owner and *transparent* under the jurisdiction where it is established. The diagram below illustrates a basic structure using this technique.

Figure 11. Payment to a Foreign Reverse Hybrid



199. In this structure A Co, a company resident in Country A (the investor jurisdiction) owns all of the shares in B Co, a foreign subsidiary established under the laws of Country B (the intermediary jurisdiction). B Co is treated as transparent for tax purposes under the laws of Country B but is regarded as a separate taxable entity under the laws of Country A. C Co, a company resident in Country C (the payer jurisdiction) borrows money from B Co and makes interest payments under the loan.

200. Payments made to a reverse hybrid can give rise to D/NI outcomes if the payment is deductible under the laws of the payer jurisdiction (Country C) but is not included in income under the laws of either the investor or the intermediary jurisdiction (Country A or B) because neither the

investor nor the intermediary jurisdiction treats the payment as income of a resident (or, more specifically, each country treats the income as being derived by a resident of the other jurisdiction).

201. While it is possible to design reverse hybrid structures where the payer and the intermediary are established in the same jurisdiction, more commonly the intermediary is established in a different jurisdiction from the payer with the result that the payment to the intermediary is treated as foreign source income and, to the extent allocated to a non-resident, outside the intermediary jurisdiction's taxing jurisdiction.

(a) *Payments to a reverse-hybrid do not necessarily result in D/NI outcomes*

202. Payments made through a reverse hybrid structure will not result in D/NI outcomes if the income is treated as sourced in the intermediary jurisdiction due to the intermediary maintaining a permanent establishment or some other form of taxable presence in that jurisdiction. In the cases of reverse hybrids, however, the intermediary will generally be structured so as to avoid having a taxable presence in its jurisdiction of establishment.

203. The payment could also be taxed under a controlled foreign company (CFC), foreign investment fund (FIF) or similar anti-deferral rule that forced inclusion of the payment in the investor jurisdiction. The key operational problem with such anti-deferral regimes (particularly in the portfolio investor context) is, however, obtaining sufficient information about the amount of deferred income derived by the intermediary to apply the anti-deferral rule.

(b) *Structure of reverse hybrids makes them difficult to address under a linking rule*

204. In the other hybrid mismatch structures considered in this Consultation Document (hybrid financial instruments and hybrid entity payments) the hybrid element used to engineer the mismatch in tax outcomes operates between the parties to the mismatch. In the case of a reverse hybrid, however, the mismatch is entirely the product of an investment structure engineered between the investor and the intermediary. Consequently reverse hybrids can be used to engineer non-inclusion outcomes in respect of almost any payment regardless of the terms under which the payment is made or the relationship between the payer and intermediary.

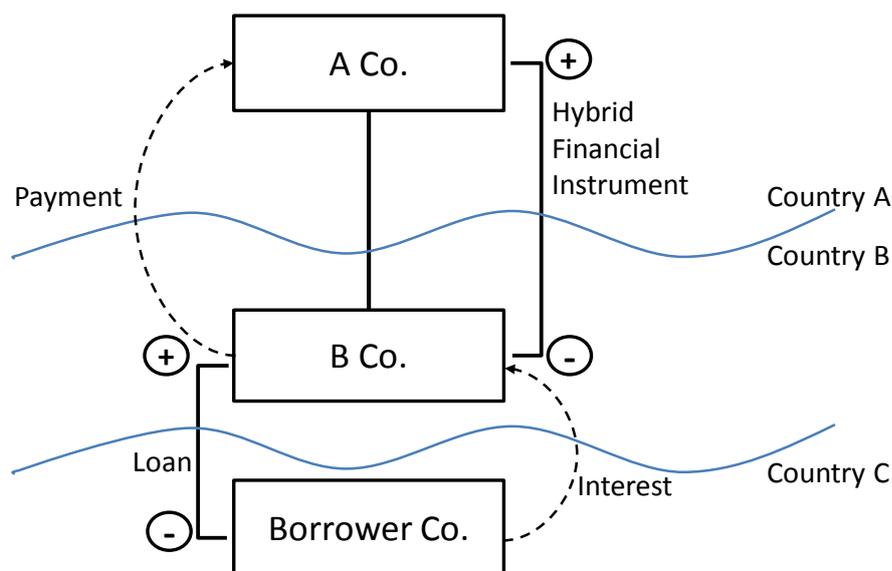
205. The mechanics of reverse hybrid structures also make it difficult for any party to the arrangement to know the nature and extent of the mismatch unless the arrangement is implemented within the confines of a controlled group. Reverse hybrids mismatches can arise in the context of widely-held investment vehicles that admit offshore investors. In such situations the investor, intermediary and payer may not be in a position to understand the tax position of the other parties to the arrangement and the payment may be made in circumstances where it is not clear to any party to the arrangement that a D/NI payment has been made. The structure of reverse hybrids therefore raises difficult issues of scope which are discussed further below.

B. *Basic imported mismatch using hybrid financial instrument*

206. In this Consultation Documents reverse hybrids are treated as a subset of a broader category of *imported mismatch arrangements*: hybrid structures created under the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction. Once a hybrid mismatch has been engineered between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter to shift the effect of that mismatch into a third jurisdiction (through the use of an ordinary loan, for example)

207. Imported mismatches rely on the absence of effective hybrid mismatch rules in the investor and intermediary jurisdictions in order to generate the mismatch in tax outcomes which can then be "imported" into the payer jurisdiction. Therefore the primary and most effective way of dealing with imported mismatches is to ensure every jurisdiction adopts effective hybrid mismatch rules. A simple example of an imported mismatch structure is illustrated in the figure below.

Figure 12. Importing Mismatch from Hybrid Financial Instrument



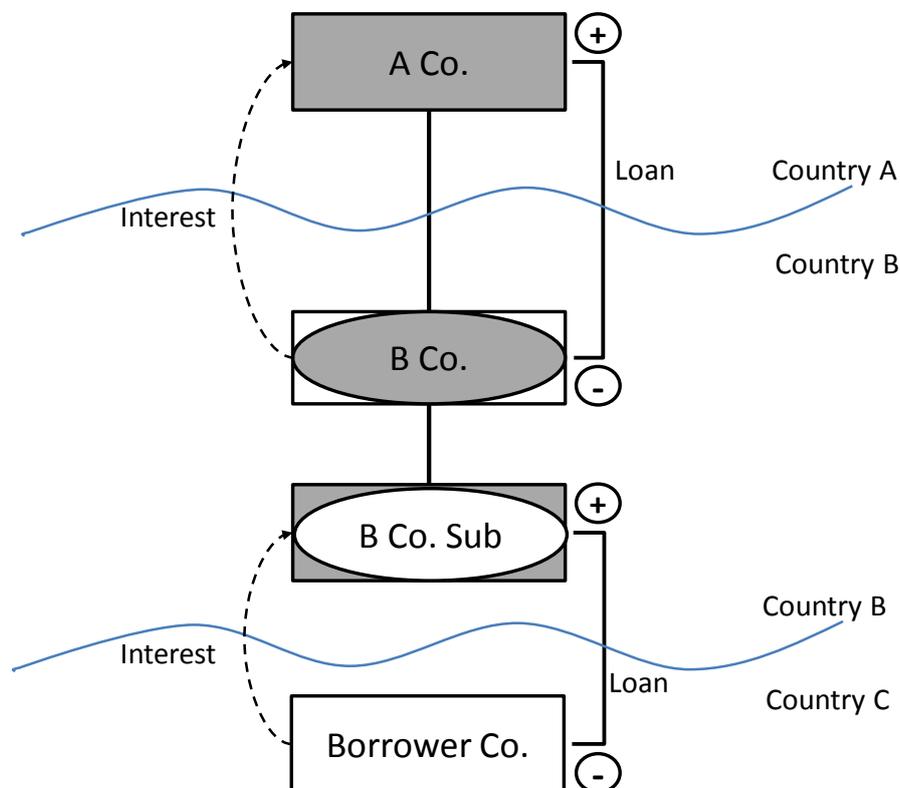
208. Under this structure, B Co is a wholly-owned subsidiary of A Co. A Co lends money to B Co using a hybrid financial instrument. The payments under this instrument will be exempt from tax under the laws of Country A, while being deductible under the laws of Country B. Borrower Co borrows money from B Co. Interest payable under the loan is deductible under the laws of Borrower Co's jurisdiction (Country C) and included in income by B Co under Country B law. The result of this structure is a D/NI outcome between Countries A and C. Country B's tax revenue is unaffected as income and deductions offset each other.

209. Imported mismatch structures are generally designed to exploit a particular tax advantage under the laws of the intermediary jurisdiction (such as entitlement to treaty benefits and/or the absence of hybrid mismatch rules) which means that the counterparty to the mismatch in tax outcomes is generally established in a different jurisdiction. Because these types of mismatch arrangements are generally revenue neutral for the intermediate jurisdiction, there will typically be little incentive on the jurisdiction to introduce measures to neutralise their effect.

C. Basic imported mismatch using hybrid entities

210. The same imported mismatch outcome can be engineered through the use of hybrid entities. Although structures that lead to this result are generally more complex than that illustrated in Figure 12, they retain the same general characteristics in that they rely on hybrid techniques for their effect and they result in a deductible expense in a third country (Country C in this example) with no corresponding inclusion at the investor level (Country A in the example). The example at Figure 13 below illustrates an imported mismatch utilising hybrid entities.

Figure 13. Tower Structure - Exporting Mismatch from Hybrid Entities into Third Jurisdiction



211. The example above is an illustration of what has been referred to as a “tower” structure. Under this structure, A Co establishes a wholly-owned subsidiary B Co which in turn owns a wholly-owned subsidiary B Co Sub. A Co lends money to B Co. B Co uses the money to acquire equity in B Co Sub. B Co Sub then lends money to Borrower Co, an unrelated entity resident in Country C.

212. B Co is a hybrid that is treated as transparent under the laws of Country A. Country A disregards the separate existence of B Co and, as a result, ignores the loan (and by extension the interest on the loan) between A Co and B Co. This part of the structure therefore gives rise to an interest deduction under the laws of Country B but no corresponding inclusion under the laws of Country A.

213. B Co Sub is a “reverse hybrid” entity from the perspective of Country A. It is treated as transparent for tax purposes under the laws of Country B but is treated as a separate taxable entity under the laws of Country A. Interest payable under the loan between Borrower Co and B Co Sub is deductible under the laws of Country C and included in income under Country B law. Country B treats B Co Sub as a transparent entity and will include its income in B Co’s income. However, the income will be offset by the interest deduction under the loan arrangement between A Co and B Co.

214. From a Country A perspective, B Co Sub’s income will not be included in A Co’s income as it is a separate Country B entity. The net result of this structure is a D/NI outcome between Country A and Country C. Again, Country B’s tax revenue is not affected as interest income and interest deductions offset each other.

D. Structural similarities

215. It can be seen that reverse hybrid and imported mismatch arrangements have a number of structural similarities. In particular:

- (a) The arrangement will typically include at least three different tax jurisdictions (the payer jurisdiction, the intermediary jurisdiction and the investor jurisdiction).
- (b) The intermediary jurisdiction may have little incentive to apply a hybrid mismatch rule to the payment.
- (c) The hybrid element that gives rise to the mismatch is a product of the investment structure between investor and intermediary. There is no hybrid element operating between payer and the intermediary and, accordingly, these structures can be used to generate D/NI outcomes in respect of almost any cross-border payment regardless of the terms under which the payment is made, or the relationship between the payer and intermediary.
- (d) The structure of the arrangement can make it difficult for the payer to know the nature and extent of the mismatch unless it arises within the confines of a controlled group.

216. The mechanical difference between reverse hybrids and other types of imported mismatches turns on the nature of the hybrid mechanism and the mismatch in tax outcomes that is attributable to that hybrid mechanism.

- (a) In respect of reverse hybrid structures, the hybrid mechanism is the direct consequence of the hybrid tax treatment of the intermediary under the laws of the intermediary and investor jurisdiction and the resulting mismatch is a straight D/NI outcome in relation to a payment made to that entity.
- (b) In respect of other types of imported mismatches, both the hybrid mechanism and the mismatch is indirect, that is to say, the payment is offset or reduced by tax relief arising under another hybrid mismatch arrangement embedded in the arrangement.

217. The difference between reverse hybrids and imported mismatch arrangements could therefore be thought of as a difference between direct and indirect mismatches engineered through the investment structure.

2. Summary of Recommendations

218. In respect of imported mismatch arrangements other than reverse hybrids, comprehensive hybrid mismatch rules in the investor or the intermediary jurisdiction should be sufficient to prevent imported mismatches being structured through those jurisdictions. The simplest and most direct way of avoiding the effect of imported hybrid mismatch arrangements is, therefore, for all countries to adopt the same set of hybrid mismatch rules. This approach would ensure that the arrangement was neutralised in the jurisdiction where the hybrid technique is deployed and there would be no resulting mismatch that could be exported into a third jurisdiction. A comprehensive solution where all countries signed up to the same set of hybrid mismatch rules would also generate compliance and administration efficiencies and certainty of outcomes for taxpayers.

219. It is still necessary, however, to address reverse hybrid structures and provide measures designed to protect the payer jurisdiction from imported mismatches generally. This Consultation

Document therefore makes two recommendations designed to neutralise the mismatch in tax outcomes caused by reverse hybrids:

(a) introduction of rules designed to neutralise reverse hybrids by:

- (i) requiring income of, or payments to, a reverse hybrid to be included under the laws of the investor jurisdiction; and
- (ii) recharacterising certain reverse hybrids by requiring income of, or payments to, a reverse hybrid to be included under the laws of the intermediary jurisdiction if not included under the laws of the investor jurisdiction.

(b) rules that would allow the payer jurisdiction to deny the deduction for payments made to an offshore structure including an imported mismatch structure or reverse hybrid where the parties to the mismatch are members of the same control group or the payer has incurred the expense as part of an avoidance arrangement.

A summary of the recommendations is set out in the box below.

Imported Mismatches and Reverse Hybrids
<p><i>Primary rule (inclusion in investor jurisdiction)</i></p> <p>a) Investor jurisdictions should implement:</p> <ul style="list-style-type: none">• specific and targeted changes to their controlled foreign companies (CFC) or foreign investment fund (FIF) rules; or• specific and targeted changes to domestic law; <p>that are effective to tax on a current basis, income of residents accrued through offshore investment structures.</p> <p><i>Secondary rule (inclusion in intermediary jurisdiction)</i></p> <p>b) Entities or arrangements that are transparent or partially transparent under the laws of the jurisdiction where they are established (i.e. intermediaries) should be treated as taxable under the laws of the intermediary jurisdiction if a controlling investor treats that intermediary as a reverse hybrid in circumstances where the income derived by that intermediary is not brought into account under the laws of the investor or the intermediary jurisdiction.</p> <p><i>Defensive rule</i></p> <p>c) The payer jurisdiction should deny the deduction for a payment to an offshore non-inclusion structure (such as a reverse hybrid or imported mismatch arrangement) to the extent the payment results in a no-taxation outcome or is offset by expenditure incurred under a hybrid mismatch arrangement and the taxpayer is part of the same control group as the parties to the mismatch or is party to an avoidance arrangement.</p> <p><i>Information reporting</i></p> <p>d) The intermediary jurisdiction should impose appropriate tax filing and information reporting requirements on intermediaries to facilitate the ability of offshore investors and tax administrations to determine the income and gains derived by the intermediary and the amounts beneficially owned by each investor.</p>

3. Technical Discussion

A. Reverse hybrids

(a) Taxation in the investor jurisdiction

220. In the context of reverse hybrids, the best person and place to tax the payment is the investor in the investor's jurisdiction of residence. The investor is the ultimate direct or indirect owner of the payment and the investor jurisdiction has the best jurisdictional basis for taxing the investor on that income. The risk of any mismatch can be eliminated by the investor jurisdiction applying anti-deferral rules, such as controlled foreign company (CFC) or foreign investment fund (FIF) rules or other rules that otherwise that tax income accrued through tax exempt offshore investment structures on a current basis.

221. A number of countries already have CFC or FIF rules that could apply to payments derived through reverse hybrid structures. In certain cases, however, these rules do not treat payments made to a reverse hybrid as included within the charge to taxation or these payments are deliberately structured in such a way as to circumvent the effect of such rules. The application of the CFC rules will be considered further in the context of Action 3. In circumstances where CFC or FIF rules are not fully effective to tax, on a current basis, income of residents accrued through reverse hybrids, then jurisdictions should introduce specific rules designed to bring the income of a reverse hybrid within the charge to taxation in the investor jurisdiction. This could be done by deeming the intermediary to be resident in the investor jurisdiction, treating the intermediary as transparent or taxing the resident holder on a deemed distribution or changes in market value of the investment in the offshore investment structure.

(b) Information requirements

222. One of the key obstacles to applying an anti-deferral rule for many countries, however, is the administration and compliance burdens they impose. In particular, it can be difficult for both investors and tax administrations to obtain sufficient information on what income has been accumulated in the offshore fund and how much has been allocated to a resident investor. For this reason the Consultation Document recommends that intermediary jurisdictions introduce or revise tax filing and information reporting requirements that would facilitate the ability of offshore investors and tax administrations to determine the income and gains derived by the entity and amounts allocated to each investor. These filing and information reporting requirements could include:

- (a) compliance with know your customer rules and collection of relevant tax information of investors;
- (b) a requirement to provide investors with timely financial and tax information;
- (c) a requirement for the intermediary to file an "advisory" return in the intermediary jurisdiction that recorded the net income of the intermediary and the amounts allocated to investors;
- (d) record-keeping requirements; and
- (e) procedures for exchanging relevant tax information with tax authorities in other jurisdictions.

Such measures do not interfere with the tax transparency of the intermediary but would assist investors and tax administrations in foreign jurisdictions to apply their domestic anti-deferral rules to investments held by residents in offshore funds.

(c) *Taxation in the intermediary jurisdiction*

223. The response recommended in this Consultation Document is that all countries adopt a rule that would re-characterise transparent and partially transparent entities established in the intermediary jurisdiction as tax resident. Because re-characterisation generally entails significant disruption to domestic law this response should be limited to situations where the intermediary is part of the same group as the investor and does not have a permanent establishment or other taxable presence in the intermediary jurisdiction. Re-characterisation will also be unnecessary if the income of the entity is subject to current taxation under the rules of the investor jurisdiction (whether under a re-characterisation rule or anti-deferral regime such as CFC or FIF rules).

B. *Deductible payments under imported mismatch structures*

224. While this Consultation Document recommends that imported mismatches be primarily addressed through anti-deferral and hybrid mismatch rules implemented in the investor and intermediary jurisdictions, the Action Plan does not contemplate a country being forced to rely on the domestic laws of other jurisdictions in order to protect their own tax base from the effect of hybrid mismatch arrangements. This Consultation Document therefore recommends a defensive mechanism where the jurisdiction of the payer denies a deduction for a payment made under an imported mismatch arrangement to the extent the payment results in a D/NI outcome.

4. *Application of the Rule*

A. *Application to reverse hybrids*

225. The effect of Country A adopting these recommendations on the reverse hybrid structure illustrated in Figure 11 would be that A Co would be required to bring into account, on a current basis, the income derived by B Co including any deductible amounts paid by C Co to B Co, thus eliminating the hybrid mismatch. The nature of the anti-deferral rules introduced by Country A would be a question for domestic law implementation however they would need to be effective to pick up income derived by a reverse hybrid. Furthermore, if Country B has adopted the tax filing and information reporting recommendations suggested in this Consultation Draft, it should be easier for Country A to ensure that the anti-deferral rule has been complied with and is operating effectively.

226. The effect of Country B adopting these recommendations would result in B Co being treated as a taxable entity under Country B law if the controlling investor (A Co) treats that intermediary as a reverse hybrid and the income derived by that intermediary is not otherwise brought into account under the laws of the investor or the intermediary jurisdiction. Thus the re-characterisation rule would not apply, for example, if the payment was taxed in the intermediary jurisdiction because B Co maintained a permanent establishment in that jurisdiction or if Country A had adopted the recommendations of this Consultation Document and the income was effectively taxed in the investor jurisdiction.

227. The effect of Country C adopting these recommendations would be that C Co would be denied the deduction for the payment. This would be on the basis that:

- (a) the payment was made to a reverse hybrid; and
- (b) the payment was not included as income by a taxpayer under the laws of Country B or A.

B. Application to imported mismatches

228. Adopting the other hybrid mismatch rules recommended in this Consultation Document should be sufficient to eliminate the effect of imported mismatches. If the hybrid financial instrument and hybrid entity payments rule is adopted in either Country A or B then the hybrid mismatches in the example illustrated in Figures 12 and 13 will be neutralised and there will be no mismatch to import into Country C.

229. The effect of Country C adopting these recommendations would be that C Co would be denied the deduction for the payment. This would be on the basis that:

- (a) the payment was made to person who was a party to a hybrid mismatch; and
- (b) the payment was included in income by the payee but was set-off against a deduction arising under that hybrid mismatch arrangement.

230. Under the example illustrated in Figure 12 the payment is made to B Co, who is a party to a hybrid financial instrument, and the receipt is offset against expenditure incurred under that hybrid financial instrument. Under the example illustrated in Figure 13 the payment is made to B Co (as B Sub 1 is transparent under Country B law) who makes a disregarded hybrid payment to A Co and the receipt is offset against expenditure incurred under that arrangement.

5. Scope

231. As noted above the nature of imported mismatches can make it difficult for the payer to know the nature and extent of the mismatch (and hence make any adjustment required under the hybrid mismatch rule very difficult) unless the mismatch arises between members of a controlled group or the payer is party to an arrangement that has been deliberately designed to produce a tax advantage. In particular, there is no hybrid element operating between payer and the intermediary in the context of an imported mismatch and, accordingly, these structures can be used to generate D/NI outcomes in respect of almost any cross-border payment regardless of the terms under which the payment is made, or the payer's relationship with the intermediate payee. While the structures produce a D/NI outcome that is similar to payments made under a hybrid financial instrument the mechanism by which the mismatch is achieved means that the nature of the information required by the payer is significantly more detailed both as to the tax treatment of the payment under the laws of the foreign jurisdiction and the way the payment has been treated by the counterparty to the mismatch. Accordingly there are a number of tax policy and detection challenges presented by reverse hybrid mismatches that point towards a more limited scope when denying the deduction for the payer.

232. The recommended scope of the rules varies depending on the position of the taxpayer in respect of the arrangement:

- (a) In respect of the investor jurisdiction there seems no reason in practice or in principle why the scope of the rule should be limited to related parties. The investor is the ultimate direct or indirect owner of the payment and the investor jurisdiction has the best jurisdictional basis for taxing the investor on that income and there is no reason why the degree of ownership or investment in the entity should limit the ability of the investor jurisdiction to apply rules designed to end deferral on untaxed income.
- (b) In respect of the intermediary jurisdiction this Consultation Document recommends that the re-characterisation rule be limited to those cases where there is a controlling investor (50% or more commonality of ownership) that treats the intermediary as a reverse hybrid.
- (c) In respect of the payer jurisdiction, this Consultation Document recommends that the deduction be denied where the payer, intermediary and investor are all members of the same control group (i.e. 50% or more commonality of ownership) or the payer is party to an avoidance arrangement designed to engineer the mismatch.

A. *Control group*

233. Provided the payer, intermediary and investor are all members of the same control group (i.e. 50% or more commonality of ownership including persons acting in concert) it should be a relatively simple matter for one party to the arrangement to determine the other parties' tax treatment of the same payment. A hybrid mismatch rule that denied a deduction for the payment in the payer jurisdiction where the counterparties to the mismatch were part of the same control group should not pose undue compliance costs on the payer and could otherwise be crafted to meet the criteria for good rule design described in Part II of the Consultation Document. Definition of control group could reflect the definition for related parties with the ownership threshold lifted from 10% to 50%. It should also include entities that are consolidated for financial accounting purposes.

B. *Structured arrangements*

234. In addition to picking up mismatches that arise within the confines of a controlled group the payer should be denied the deduction if they have entered into an arrangement designed to engineer a D/NI outcome. This rule would apply whenever a deductible payment was made in circumstances where the corresponding receipt was not taxed and the payer was a party to an avoidance arrangement.

235. This question would need to be determined on the facts and circumstances of the case. Factors that might indicate the payer was party to the imported mismatch arrangement would include circular fund flows and the insertion of accommodation parties and financial intermediaries to avoid the control group test.

(a) *Safe-harbours*

236. While such an anti-abuse rule creates a measure of uncertainty for the payer, jurisdictions could consider providing safe-harbours so that the payer would not be at risk of losing the deduction if, for example, the payment is subject to a full rate of withholding tax or the payee is established in a jurisdiction that has introduced comprehensive hybrid mismatch rules (including the re-characterisation and information reporting recommendations set out above).

Box 4. Questions for Consultation

1. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?
2. Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply?
3. How could an anti – abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?

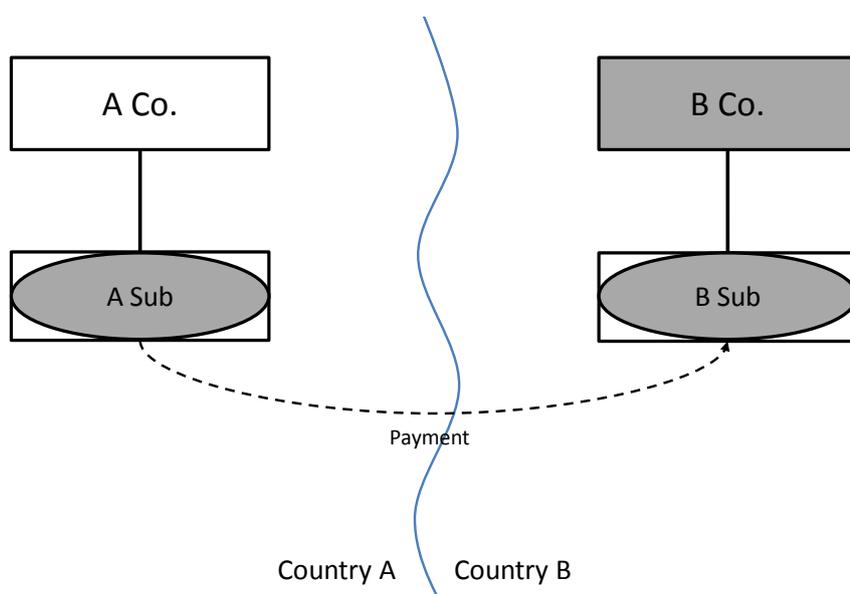
VII. FURTHER TECHNICAL DISCUSSION AND EXAMPLES

1. Technical Discussion

A. Meaning of “payer” and “payee”

237. Linking rules seek to identify whether the results in one jurisdiction align with the results in another jurisdiction. One of the challenges in applying such linking rules is that the taxpayer who is treated as the recipient of the payment under the laws of the counterparty jurisdiction may not be the payee under the laws of the payer’s jurisdiction. The figure below illustrates this outcome.

Figure 14. Conflict in Characterisation of Payee and Payer



238. In the example illustrated above, A Sub is a company resident for tax purposes in Country A. A Sub makes a payment to B Sub. Both A Sub and B Sub are disregarded entities for Country B purposes. Thus, under Country A law, the payment is treated as being made between A Sub and B Sub. Under Country B law, however, A Sub and B Sub are disregarded and the payment is treated as being made between A Co and B Co. When applying a linking rule that, for example, denies the deduction for the payer (A Sub) in circumstances where the payee has not included a corresponding amount in income, it will be the tax treatment of the payee under the rules of the other jurisdiction (i.e. B Co under Country B law) that is relevant to the determination of whether there is any mismatch in tax treatment in connection with the payment.

239. Identification of the payer or payee thus depends on the context in which the question is being asked: if the question pertains to a mismatch in tax treatment under the laws of another jurisdiction then it is that jurisdiction’s rules that should be used to determine whether a mismatch has arisen. This does not require one jurisdiction to adopt the tax rules of another, or for two jurisdictions to harmonise their

payment rules, it is simply that the rules for determining the payee or the payer in the counterparty jurisdiction form part of the contextual background for construing the meaning of the words used in the domestic legislation.

240. The taxpayer would generally apply its own domestic tax rules to determine the relevant jurisdiction of the payee (or payer as appropriate). The taxpayer could then use the rules of that jurisdiction to identify the payee (or payer as appropriate) for the purposes of the hybrid mismatch rule. Thus, in the example above, A Sub would apply its own country's rules to determine that the payment was made to B Sub (a person established under the laws of Country B). It would then apply the rules of the country of establishment (Country B) to identify the relevant payee for the purposes of determining whether there has been a mismatch under the hybrid mismatch rule. Similarly, while B Co would treat A Co as the payer under its domestic law, it would look to the person treated as actually making the payment under Country A law (A Sub) to determine whether any mismatch has arisen.

B. Rule co-ordination

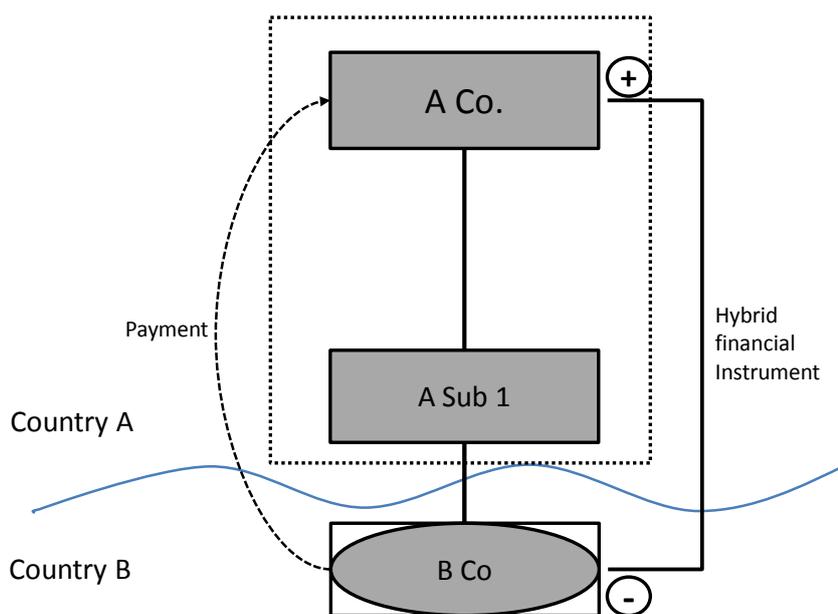
(a) Co-ordination with other domestic rules

241. In general the hybrid mismatch rule is a discrete rule that alters the specific tax effects of a particular transaction and it will generally be applied *after* the other rules of the domestic law have determined the character and outcomes of the arrangement but *before* the application of any general non-transaction specific limitation such as a thin capitalisation rule. Thus, in the context of hybrid financial instruments, a hybrid mismatch rule limiting interest deductibility would apply after the character of the payment had been determined but before a general limitation on interest deductibility.

(b) Co-ordination between hybrid mismatch rules

242. There may also be circumstances where different hybrid rules could apply to the same arrangement. In such cases an ordering rule is required to determine which hybrid mismatch rule should be applied first. The example below illustrates this issue.

Figure 15. Application of Hybrid Financial Instrument and Hybrid Entity Payment Rule



243. A Co owns all of the shares in A Sub 1. Both A Co and A Sub 1 are companies resident in Country A and are consolidated for tax purposes under Country A law. The effect of this tax consolidation is that payments between A Co and A Sub 1 are ignored for Country A tax purposes. A Sub 1 establishes B Co, a subsidiary in Country B. B Co is disregarded under Country A law. B Co and A Co enter into a hybrid financial instrument (i.e. a financial instrument that would have given rise to a mismatch if it had been directly entered into between ordinary taxpayers resident in the relevant jurisdiction).

244. In this example there are two hybrid mismatch rules that could be invoked to address this type of arrangement. The first is the hybrid financial instrument rule (where the primary rule would be to deny the entire deduction in Country B) and the second is the hybrid entity payment rule (where the primary rule would be to deny the deduction in Country B but only to the extent the payment exceeds B Co's dual inclusion income).

245. The taxpayer should determine whether it is entitled to deduct any portion of the payment under the hybrid financial instrument rule before it considers the potential application of a rule designed to prevent base erosion through duplication of losses. The hybrid financial instrument rule is easier to apply and addresses a broader range of arrangements. The policy rationale behind the hybrid financial instrument rule is to align the tax outcomes for payments made under all financial instruments that produce mismatches (not simply between parties in the same chain of ownership) and seeks to bring the tax results in line with the assumptions made by the tax policy designers when the deduction or tax relief was granted under domestic law. The policy rationale for the hybrid entity payment rule is narrower and more targeted. It applies only to entities that are closely-held and only operates to the extent a duplicate deduction can be off-set against non-dual inclusion income.

246. Accordingly, in this case the hybrid financial instrument rule should be applied first, to deny the deduction for the entire amount of the payment to the extent it would not give rise to ordinary income under the laws of Country A. If Country B has not introduced hybrid mismatch rules, however, then Country A would ultimately apply the hybrid entity payment rule as a defensive measure, because, on the example given above, applying the hybrid financial instrument rule would not, under Country A law, result in A Co including any amount of income (as the payment is disregarded under the consolidation regime of Country A).

Box 5. Questions for Consultation

1. Do these technical recommendations assist in understanding and applying the rules?
2. Are there further technical recommendations that should be addressed in the final report?

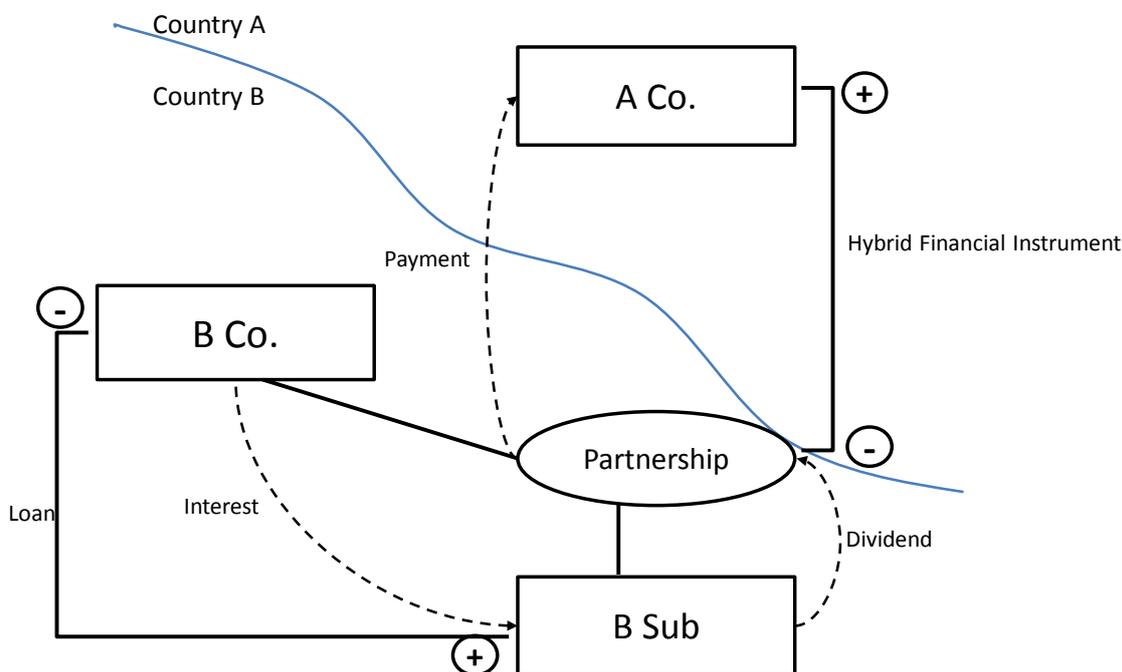
2. Examples

A. Hybrid financial instruments

(a) Issue of hybrid financial instrument by a transparent entity

247. The recommendations set out in Part IV are intended to neutralise the effect of hybrid mismatch arrangements that rely on the use of hybrid financial instruments issued by transparent entities. The example below illustrates a foreign tax credit generator transaction incorporating a hybrid financial instrument issued by a tax transparent entity.

Figure 16. Foreign Tax Credit Generator Transaction involving use of Hybrid financial Instrument



248. In this structure B Co (a company resident in Country B) establishes a tax transparent partnership in Country B. The partnership establishes a wholly-owned subsidiary (B Sub) which is tax resident in Country B. The partnership is funded with an equity contribution by B Co and through a hybrid financial instrument issued by the Partnership to A Co. The Partnership subscribes for ordinary shares in B Sub which loans the subscription proceeds to B Co.

249. From Country B's perspective, B Co is treated as holding all the equity interests in the Special Purpose Vehicle (SPV) (as the hybrid financial instrument is a debt instrument for Country B purposes). B Co is also treated as entitled to an exemption, credit or other tax relief on all the dividends paid by B Sub. The tax transparency of the partnership means that, from Country B's perspective, the hybrid financial instrument is treated as a loan from A Co to B Co. The net outcome from Country's B's perspective therefore is an exempt dividend return from B Sub and a deductible expense on the payments made by the partnership under the hybrid financial instrument.

250. Under Country A law, A Co is treated as an equity investor in the partnership and the return on the hybrid financial instrument is treated as an allocation of the profits of the partnership. Assuming Country A provides an exemption or indirect foreign tax credit for the tax paid on the dividend from B Sub then the net effect of the arrangement from Country A's perspective is a D/Ni outcome on payments made under the hybrid financial instrument.

251. The effect of introducing the draft rule into the domestic laws of Country A would be as follows: all the payments made under the instrument are payments made under a hybrid financial instrument. The "payer" under the financing arrangement is B Co (tax resident in Country B) while the payee under the financing arrangement is A Co (tax resident in Country A).

252. As a threshold matter the Consultation Document recommends that Country A deny A Co the benefit of any dividend exemption where the payer of the dividend (as determined under Country A law)

has claimed a deduction for the payment. B Sub has not, however, claimed a deduction for the dividend paid to A Co and this rule would therefore not impact on A Co's tax position under the hybrid financial instrument rule.

253. Accordingly the primary rule would be that B Co would be denied a deduction for the payments made under the hybrid financial instrument to the extent A Co did not treat such payments as ordinary income under the laws of Country A, with A Co applying a defensive rule in the event that B Co does not deny the deduction.

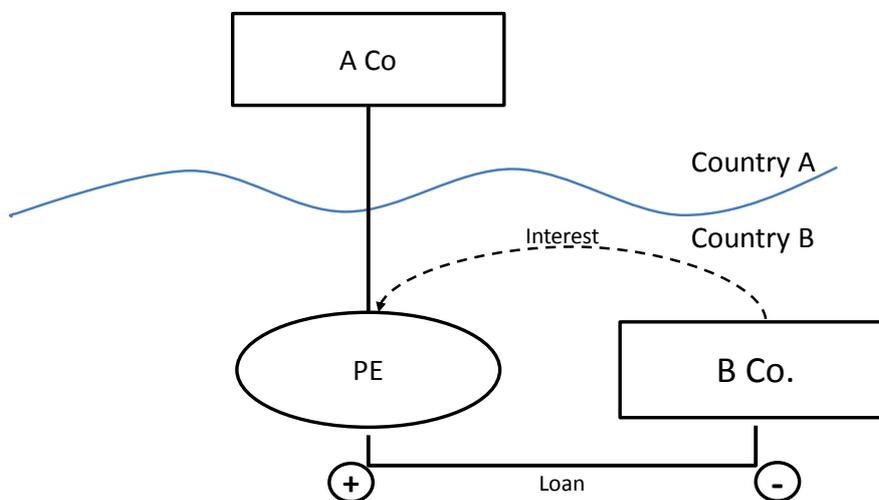
(b) *Application to hybrid financial instrument rule to branches*

254. Although the hybrid financial instrument rule does not contain a specific exception for instruments held through foreign branches the rule should not apply to negate the effect of a participation exemption granted for financial instruments held through a foreign branch. Any adverse impact on a branch exemption should be avoided by ensuring that the rule applies only to the extent that the mismatch in tax outcomes is attributable to the terms of the instrument rather than the circumstances in which it is held. The examples below illustrate how the rule is intended to operate.

(i) Branch located in payer's jurisdiction

255. In the example illustrated below, A Co, a company resident in Country A, lends money to B Co through a permanent establishment in Country B. It is assumed that the interest is taxable in Country B and that Country A exempts interest paid to foreign branch.

Figure 17. Payment to a Branch in Same Jurisdiction as Payer



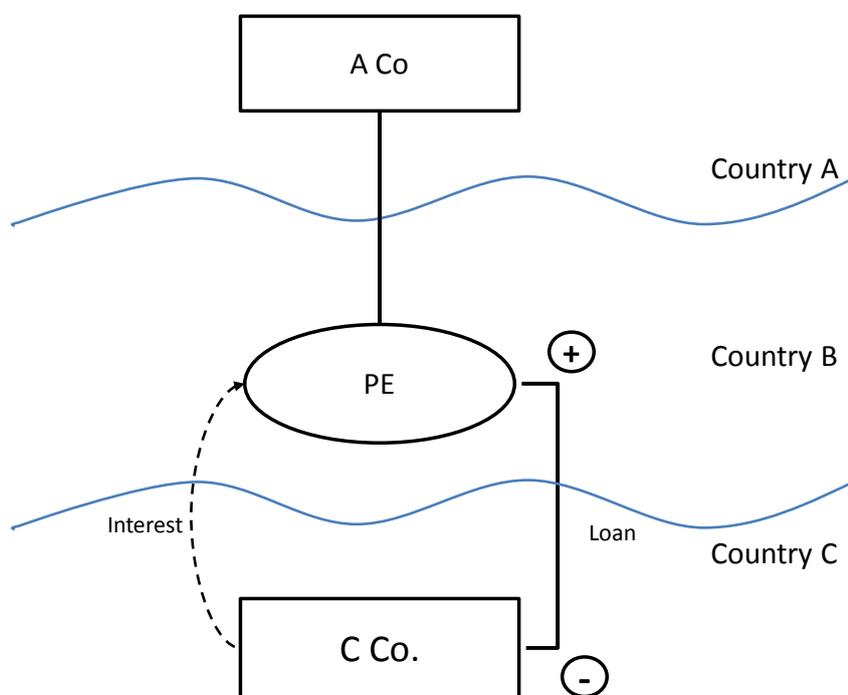
256. This structure should not generally give rise to a mismatch in tax outcomes. Although the payment is not included under the laws Country A, it will generally be included under the laws of Country B (as the permanent establishment will generally be taxable).

(ii) Branch located in a third jurisdiction

257. The figure below illustrates how the rule might operate in the context of a branch located in a third jurisdiction. In the example illustrated below, A Co, a company resident in Country A that is lending

money to C Co through a permanent establishment in Country B. Assume that Country A exempts income of a foreign branch and the payment gives rise to a mismatch in tax outcomes.

Figure 18. Payment to a Branch Located in an Intermediate Jurisdiction



258. As with the example above, if Country B taxes the income received by the branch there will be no D/Ni outcome. If, however, the income from the loan is not treated as taxable in Country B then the following analysis would apply under the laws of Countries C, B and A respectively.

259. Application of the rule under Country C law: The loan should be regarded as a hybrid financial instrument and Country C can apply its hybrid mismatch rule if the same arrangement entered into directly between a resident of Country B or Country A would have given rise to a mismatch. The fact that A Co would not have been subject to any additional tax liability under its own hybrid mismatch rule (see the discussion below) does not affect whether the instrument should be treated as a hybrid financial instrument under the laws of Country C

260. Application of the rule under Country B law: If the terms of the loan give rise to a hybrid financial instrument under Country B law, but Country C does not have effective hybrid mismatch rules, then Country B can require the payment to be included in income under the defensive rule

261. Application of the rule under Country A law: The hybrid mismatch rule in Country A will not result in any additional tax liability for A Co. This is because:

- (a) the mismatch is attributable to the branch exemption and not the terms of the instrument in which case the instrument is not a hybrid financial instrument under the laws of Country A; or
- (b) the instrument is a hybrid financial instrument (i.e. the same arrangement entered into directly between a resident of Country A and Country C would have given rise to a mismatch) but the response under the hybrid financial instrument rule (treating the mismatch payments as

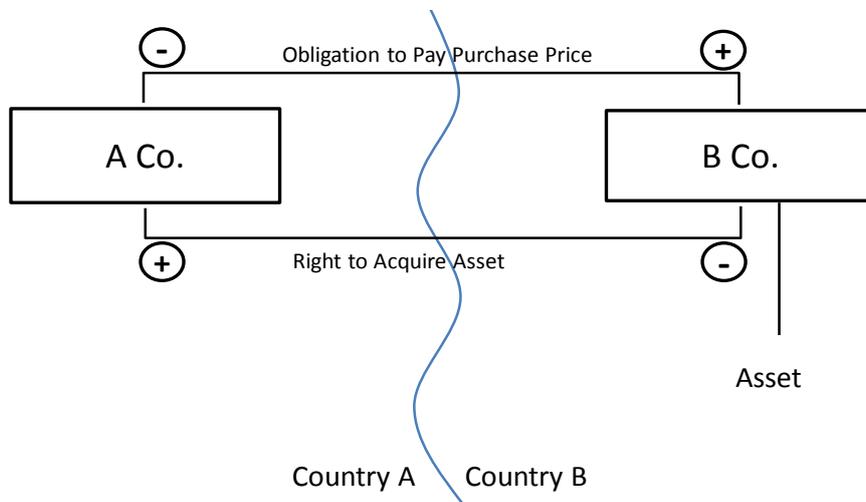
ordinary income) will not affect the overall tax position of A Co because such income will remain subject to the branch exception. Note, however, that if such payment gives rise to D/NI outcome that is attributable to the fact that the branch is located in a no-tax jurisdiction this may implicate the rule applicable to payers in respect of imported mismatch arrangements.

B. Hybrid transfers

(a) *Collateralised loan repo using a tax exemption.*

262. The discussion in Part IV indicates that the D/NI mismatch can be engineered through a repo transaction utilising an exemption for gain on the sale of an asset. An example of this structure is illustrated below.

Figure 19. Simple Collateralised Loan Repo Utilising Tax Exemption



263. In this example A Co engages in a sale and repurchases transaction with B Co over an asset. The premium paid by A Co under the repo is treated as financing expense while for B Co the entire purchase price is an exempt receipt. The table below illustrates a simple tax calculation for A Co and B Co.

Table 4. Taxation of Repurchase Premium on Collateralised Loan Repo

	A Co		B Co	
Net income calculation	Premium on purchase	(70)	Premium on sale	70
	Net income	(70)	Net income	0
Net taxable income		(70)		0
Tax credit at 30%		21		0
Country A – net credit		21		0
Country B – net tax		0		0

264. Because the sale of shares is treated as a tax exempt gain under the laws of Country B, the premium paid on sale does not give rise to any additional income for B Co and the overall arrangement thus produces a D/NI outcome as between A Co and B Co.

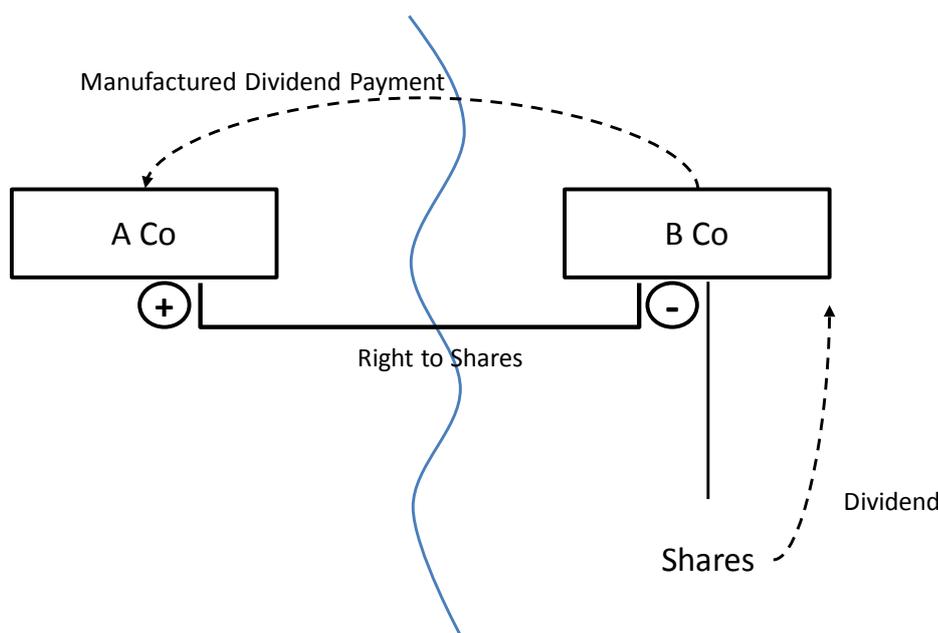
265. The effect of the hybrid mismatch rules on such a repo would be as follows:

- (a) The repo will be a hybrid transfer if A Co and B Co are both regarded as the owner of the same asset under the laws of their own jurisdiction. Even if A Co does not treat itself as the owner of the asset it may, nevertheless, treat the repo as a financial instrument and accordingly this leg of the transaction may nevertheless be caught by the hybrid financial instrument rule.
- (b) The effect of the hybrid mismatch rule would be to deny A Co a deduction for the premium to the extent such payment is not brought into account as ordinary income by the payee (B Co) under the laws of Country B.

(b) *Share lending arrangements*

266. As noted in Part IV above it is also possible to structure a repo as a share lending arrangement so that the payer / borrower under the hybrid mismatch arrangement is the entity acquiring the shares rather than the entity selling the shares. Share lending arrangements are commonly used by securities traders as hedging transactions or to gain exposure to a stock by selling the security “short” in the expectation that its price will fall. Such arrangements can also be used, however, to engineer hybrid mismatches. An example of such an arrangement is illustrated below.

Figure 20. Share Lending Repo



267. Under this arrangement the acquirer of the shares (B Co) does not advance funds to the transferor (A Co) at the outset of the arrangement. Rather the obligations of B Co remain outstanding during the term of the arrangement and are generally secured by B Co posting cash or other collateral to an account controlled by A Co. B Co’s obligations will generally include the requirement to make “manufactured payments” to A Co of any dividends that are paid on the shares during the period of the loan (the “manufactured payment”).

268. Unlike in the collateralised loan repo where B Co (the acquirer of the shares) is regarded as the lender under the arrangement and is generally protected from changes in value of the underlying collateral, in this case B Co is generally considered to be “borrower” of shares under the arrangement and has an inverse exposure to changes in share value (although if B Co retains the underlying share then B Co’s “short position” under the arrangement may hedge B Co’s investment in the shares themselves).

269. The manufactured payment may be treated as a dividend on the underlying shares in Country A but a deductible expense under Country B law thus producing a D/Ni outcome under the arrangement. A simplified illustration of the tax consequences of such an arrangement are set out below:

Table 5. Taxation of Share Lending Repo

	A Co		B Co	
Net income calculation	Manufactured payment	70	Dividend from B Sub	70
	Indirect tax credit	30	Manufactured payment	(70)
	Net income	100	Net income	0
Net taxable income		100		(70)
Tax at 30%		(30)		21
Indirect tax credit		30		
Country A – net tax		0		0
Country B – net credit		0		21

270. A dividend of \$70 is paid to B Co. B Co pays the cash amount of the dividend across to A Co as a deductible manufactured payment. A Co treats the total dividend as income (including an indirect tax credit of \$30). Because, however, the indirect credit shelters A Co’s tax liability A Co has no net tax to pay under the arrangement while B Co has a surplus deduction attributable to the manufactured payment that it can set-off against other income.

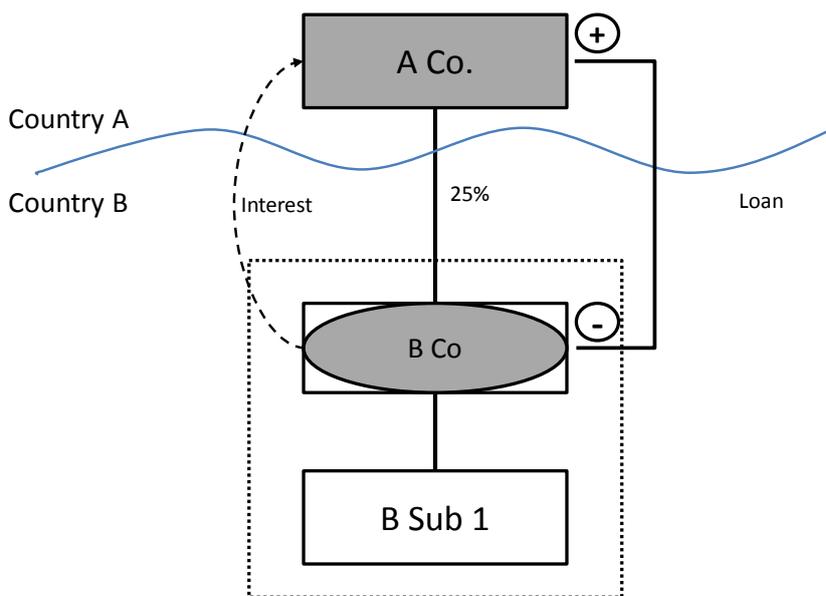
271. The effect of hybrid mismatch rules on such a share loan repo would be as follows:

- (a) The dividend exemption will not apply unless the issuer of the shares claims a deduction for the dividend payment.
- (b) The share loan is a hybrid transfer as both A Co and B Co are regarded as the owner of the same shares under the laws of their own jurisdiction.
- (c) As the arrangement is a hybrid transfer any jurisdiction that grants relief for tax withheld at source on a payment made under the arrangement (e.g. withholding tax on the dividend) should restrict the benefit of such relief to the net taxable income under the arrangement.
- (d) The effect of the hybrid mismatch rule would be to deny B Co a deduction for the manufactured payment to the extent such payment is not brought into account as ordinary income by the payee (A Co) under the laws of Country A. If Country B did not have a hybrid mismatch rule then Country A would require the manufactured payment to be included as ordinary income to the extent a deduction was granted for those payments under the law of Country B.

C. Hybrid entity payments

272. The recommendations in Part V of the Consultation Document in relation to deductible hybrid payments will apply to payments made by a hybrid entity to an owner in a foreign jurisdiction that treats the hybrid entity as transparent for tax purposes. The figure below provides a simple illustration of this type of hybrid mismatch arrangement.

Figure 21. Payment by a Partnership to a Partner



273. Under this structure B Co is a hybrid entity 25% owned by A Co (a company tax resident in Country A). A Co lends money to B Co. The tax laws of Country A treat B Co as a partnership. Rather than payments by partnerships being disregarded under Country A law all the items of income, gain and expenditure derived and incurred by B Co are allocated (under Country A law only) through to A Co in accordance with A Co’s proportionate interest in B Co. A Co is therefore treated as incurring 25% of the interest expense incurred by B Co.

274. Under Country A law, both the income from interest payment and the deduction from the interest expense are set off against each other on the same tax return so that only net 75% of the interest payment (effectively the portion of the interest cost economically borne by the other investors) is included in A Co’s income. Assuming that B Co has \$1,000 of interest expense under the loan and no income. A simplified tax calculation for A Co (assuming a corporate tax rate of 30%) can be illustrated as follows:

Table 6. Payment by a Partnership to a Partner (simplified tax calculation)

	A Co	
net income calculation	Interest on loan	1,000
	Minus non-cash deduction for interest expense	(250)
	Net income	750
Net taxable income		750
(tax) / refund at 30%		(225)
After tax return		775

275. While A receives interest income of \$1,000, the net income under the arrangement is reduced by the portion of the interest expense on the loan that is allocated to A Co under Country A laws. The net effect of this allocation is that A Co is taxable only on \$750 of interest income, resulting in a total Country A tax liability of \$225 on a gross interest receipt of \$1,000.

276. The entire interest payment is a deductible hybrid payment under the hybrid entity payment rule because it is eligible to be set off against dual inclusion income (i.e. income of B Sub 1 under the tax consolidation regime) and a duplicate deduction for the same payment has arisen for an investor in another jurisdiction. Accordingly, under the primary rule, the duplicate deduction in Country A should be denied to the extent that exceeds the investor's dual inclusion income. Based on the above simplified tax calculation, A Co's dual inclusion income is *nil* as the interest paid on the loan is not subject to tax in Country B. The net effect of the rule therefore is that A Co will be denied the deduction for the non-cash interest expense and be required to include the full \$1,000 of interest income without an offsetting deduction.

SUMMARY OF QUESTIONS FOR CONSULTATION

1. Design of Hybrid Mismatch Rules

1. Are the objectives and design principles of the hybrid mismatch arrangements clear?
2. If further clarification is required, then where is this required and how could it best be provided?

2. Hybrid Financial Instruments & Transfers

1. Is it clear what elements need to be present in order for the rules neutralising hybrid financial instruments or hybrid transfers to apply?

2. Is the outcome of the rules' operation clear?

3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?

4. This document sets out two possible approaches to drafting a scoping rule and summarises the possible advantages and disadvantages. Are the advantages and disadvantages accurately described and are there any other advantages and disadvantages of the two approaches?

(a) What is the perceived impact of a bottom-up or top-down approach in terms of tax compliance and tax administration?

5. This part includes a number of examples: -

(a) What commercial or legal difficulties might these examples give rise to where the parties to an arrangement are unconnected and have no knowledge of the counterparties position?

(b) In this context are there any examples or situations that are more problematic than others? If so please explain why problems arise and what constraints or restrictions the parties might face in obtaining relevant information on the treatment of the counterparty?

(c) To the extent that there are difficulties, do these apply equally to both the holder and issuer in the context of hybrid financial instruments?

(d) Are there any other situations or examples, not covered here that give rise to difficulties? In particular are there any specific problems for regulated businesses (see also Q. 8 below)?

6. What definition could be used to capture the concept of widely-held or regularly traded whilst also addressing concerns that any exemption should not be available to related parties, parties acting in concert or parties to a structured arrangement (i.e. an arrangement designed to obtain the benefit of a mismatch).

7. If the rule exempted certain traded instruments then how could it be drafted so that it still applied to structured arrangements?

8. In relation to regulatory capital

- (a) What are the regulatory requirements for banks' to issue/manage capital at top holding company level, and what arrangements are used to pass this down the group? For example, what use is made of identical and traceable instruments and under what conditions would the arrangement be funded by a market issuance at top holding company level?
- (b) Are special provisions needed to create parity between a banking group issuing hybrid regulatory capital indirectly to the market through its holding companies and a banking group (or another industry group) issuing hybrid regulatory capital directly to the market?
- (c) Are hybrid regulatory capital instruments sufficiently different as to justify a full carve-out from hybrid mismatch rules? Are there inherent safeguards in place against the use of these instruments for tax-planning purposes or what safeguards could be introduced to ensure that any exemption from the general hybrid mismatch rules could not be abused?

3. Hybrid Entity Payments

1. Is it clear what elements need to be present in order for the rules neutralising deductible hybrid entity payments to apply?
2. Is the outcome of the rules' operation clear?
3. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?
4. Are there any related party structures where the hybrid entity may have difficulty in knowing or obtaining information about the position of the investor?
5. If so when would these arise and what difficulties or constraints would the hybrid entity face?

4. Imported Mismatches and Reverse Hybrids

1. Are there any arrangements which should be caught by the rules but are not addressed in the recommendations?
2. Is it clear what elements need to be present in order for the defensive rule neutralising reverse hybrids and imported mismatches to apply?
3. How could an anti – abuse provision be drafted so that it prevents otherwise unrelated parties from entering into arrangements to exploit mismatch arrangements?

5. Further Technical Discussion and Examples

1. Do these technical recommendations assist in understanding and applying the rules?
2. Are there further technical recommendations that should be addressed in the final report?