



Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues



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TAX POLICY AND COMPLIANCE ISSUES

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Introduction

1. The past decades have witnessed a constant increase in the level of sophistication in the structuring of cross-border transactions. These developments pose important challenges to revenue authorities and tax policy makers, by constantly challenging their ability to keep pace with complex transactions. *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure* (2011) already underlined the importance of obtaining timely, targeted and comprehensive information. The availability of such information is important to allow governments to identify risk areas in a timely manner and be able to quickly decide whether and how to respond, thus also providing increased certainty to taxpayers. Several countries have therefore introduced complementary disclosure initiatives aimed at improving their capability to work in real time.

2. Other important challenges to revenue authorities and tax policy makers relate to the need to ensure that tax does not produce unintended and distortive effects on cross-border trade and investment. Although countries freely choose how to set-up their tax system and the elements thereof, in a globalised world where economies are increasingly integrated, it is essential to consider how tax systems interact with each other. This is relevant not only to eliminate obstacles to cross-border trade and investment, but also to limit the scope for unintended non-taxation.

3. This report deals with hybrid mismatch arrangements. These are arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries. Hybrid mismatch arrangements have been encountered by tax administrations in many countries. They often lead to “double non-taxation” that may not be intended by either country, or may alternatively lead to a tax deferral which if maintained over several years is economically similar to double non-taxation.

4. Some issues raised by hybrid mismatch arrangements have already been highlighted in a number of earlier OECD reports. For example, *Addressing Tax Risks Involving Bank Losses* (2010) highlighted the issue in the context of international banking and recommended revenue bodies to “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, *Corporate Loss Utilisation through Aggressive Tax Planning* (2011) recommended countries to “consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results”.

5. Hybrid mismatch arrangements may significantly reduce overall tax for taxpayers. Although there are no comprehensive data on the collective tax revenue loss caused by hybrid mismatch arrangements, anecdotal evidence shows that the amounts at stake in a single transaction or series of transactions are substantial. For example, New Zealand settled in 2009 cases involving 4 banks for a combined sum exceeding NZD 2.2 billion (EUR 1.3 billion).¹ Italy recently reported that it has settled a number of cases involving hybrids for an amount of approximately EUR 1.5 billion. In

1 <http://www.ird.govt.nz/aboutir/media-centre/media-releases/2009/media-release-2009-12-23.html>

the United States, the amount of tax at stake in 11 foreign tax credit generator transactions has been estimated at USD 3.5 billion.²

6. Even though most taxpayers are generally aware of the likely classification of instruments, entities or transfers and that they will therefore avoid using arrangements where they see a risk of double taxation, mismatches in the classification of instruments, entities or transfers may nevertheless raise double taxation issues. The report does not address the tax treaty implications of hybrid mismatch arrangements, which are being addressed by Working Party No. 1 on Tax Conventions and Related Questions.

7. In addition to describing the most common types of hybrid mismatch arrangements and the effects they aim to achieve, the report summarises the tax policy issues raised by these arrangements and describes the policy options to address them, with a focus on domestic law rules which deny benefits in the case of hybrid mismatch arrangements and countries' experiences regarding their application. The report ends with conclusions and recommendations for tax administrations and tax policy makers.

8. The report was prepared by the Working Party No. 10 on Exchange of Information and Tax Compliance of the Committee on Fiscal Affairs (CFA), with the assistance of its Aggressive Tax Planning (ATP) Steering Group. The following countries participated in the focus group that drafted the report: Australia, Austria, Canada, Chile, Denmark, France, Germany, India, Israel, Italy, Japan, Mexico, the Netherlands, New Zealand, Norway, South Africa, Spain, Sweden, the United Kingdom and the United States.

2 Letter from Mark W. Everson, Commissioner of Internal Revenue, to The Honorable Charles E. Grassley, Chairman, Senate Committee on Finance (19 May 2006), *in* 2006 Tax Notes Today 114-21 (14 June 2006).

Chapter 1

Hybrid Mismatch Arrangements

9. While there can be several layers of complexity, arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries are often based on similar underlying elements and aim at achieving similar effects. This section describes the most common elements of hybrid mismatch arrangements, illustrates their intended effects and contains some examples.

A. Elements of hybrid mismatch arrangements

10. Hybrid mismatch arrangements generally use one or more of the following underlying elements:

- *Hybrid entities*: Entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.
- *Dual residence entities*: Entities that are resident in two different countries for tax purposes.
- *Hybrid instruments*: Instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.
- *Hybrid transfers*: Arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralised loan.

B. Effects of hybrid mismatch arrangements

11. In terms of the results hybrid mismatch arrangements aim at achieving, they generally fall within one of the following categories:

- *Double deduction schemes*: Arrangements where a deduction related to the same contractual obligation is claimed for income tax purposes in two different countries.
- *Deduction / no inclusion schemes*: Arrangements that create a deduction in one country, typically a deduction for interest expenses, but avoid a corresponding inclusion in the taxable income in another country.
- *Foreign tax credit generators*: Arrangements that generate foreign tax credits that arguably would otherwise not be available, at least not to the same extent, or not without more corresponding taxable foreign income.

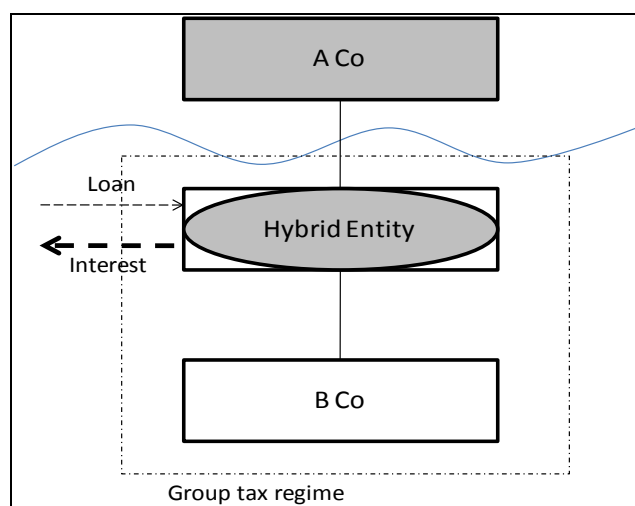
C. Examples

12. The following examples illustrate double deduction, deduction / no inclusion, and foreign tax credit generator schemes.

Double deduction

13. In a typical case a parent company in country A (“A Co”) indirectly holds an operating company in country B (“B Co”). Inserted between A Co and B Co is an entity (“Hybrid Entity”) that is treated as transparent or disregarded for country A tax purposes and as non-transparent for country B tax purposes. A Co holds all or almost all equity interest in Hybrid Entity which in turn holds all or almost all equity interests in B Co. Hybrid Entity borrows from a third party and uses the loan amount to inject it as equity into B Co (or to buy the shares in B Co from either another company of the same group or from an unrelated third party). Hybrid Entity pays interest on the loan. Apart from the interest, Hybrid Entity does not claim any other significant deductions and does not have any significant income.

Figure 1. “Double deduction” with hybrid entity



14. For country B tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country B group companies’ income under the country B group relief regime. In contrast, country A treats Hybrid Entity as transparent or disregarded, with the consequence that its interest expenses are allocated to A Co, where they can be deducted and offset unrelated income.

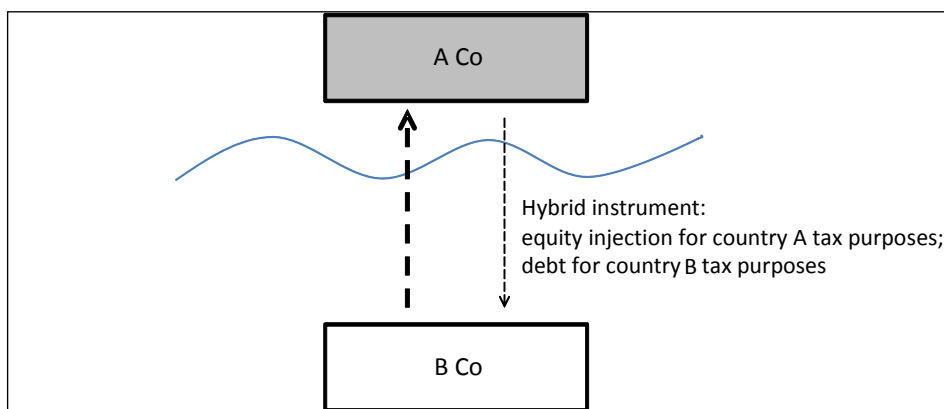
15. The effect of the scheme is thus two deductions for the same contractual obligation in two different countries. Similar effects can also be achieved through different schemes, for instance through the use of a dual resident company instead of a hybrid entity where such a dual resident company has a loss and it can benefit from group relief / tax consolidation systems in both countries.

Deduction / no inclusion

16. A company resident in country B (“B Co”) is funded by a company resident in country A (“A Co”) with an instrument that qualifies as equity in country A but as debt in country B. If current payments are made under the instrument, they are deductible

interest expenses for B Co under country B tax law. The corresponding receipts are treated as exempt dividends for country A tax purposes.

Figure 2. "Deduction / no inclusion" with hybrid instrument



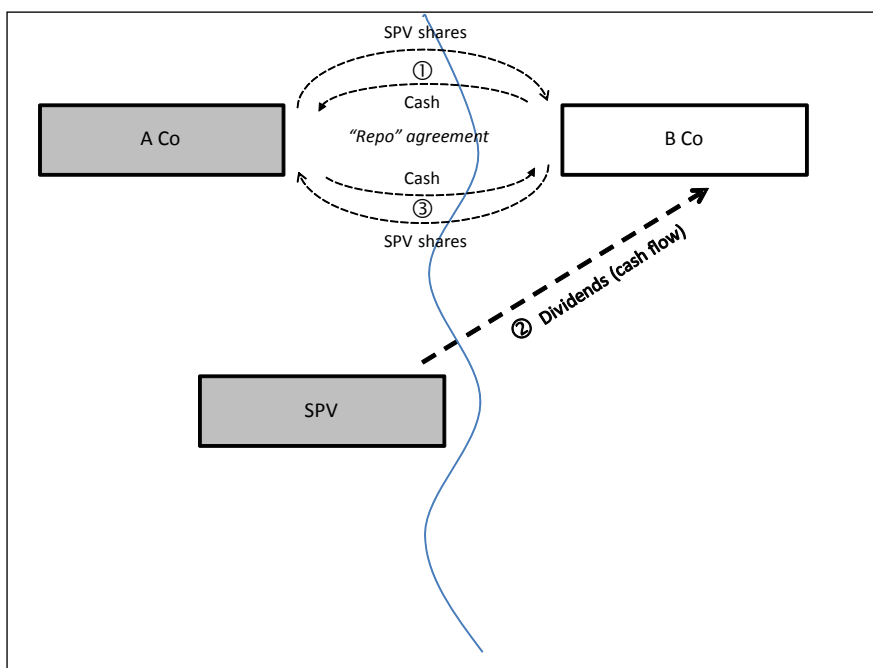
17. As a result, a net deduction arises in country B without a corresponding income inclusion in country A. Similar results can also be achieved through the use of hybrid entities (*e.g.* if an entity treated as non-transparent in the country in which it is organised makes a deductible payment to its shareholder(s), whose country of residence treats the foreign entity as transparent thus disregarding the payment for tax purposes) and of hybrid transfers (*e.g.* if two companies enter into a sale and repurchase agreement over the shares of a special purpose vehicle (SPV) and one country treats the transaction as a sale and repurchase of the SPV shares while the other country treats the transaction as a loan secured through the SPV shares).

Foreign tax credit generators

18. One of the typical schemes to generate a foreign tax credit uses a hybrid transfer of an equity instrument. The most common way to create a hybrid transfer of an equity instrument is with a sale and repurchase agreement concerning shares, where the transaction is treated as a sale and a repurchase of the shares in one country, while in the other country it is treated as a loan with the shares serving as collateral.

19. The basic structure involves a company in country A ("A Co") typically seeking financing from a company in country B ("B Co"). A Co establishes a special purpose vehicle ("SPV"), contributes equity in exchange for (preferred) shares in SPV and enters into a repo over the preferred shares with B Co. According to the repo, A Co sells the SPV preferred shares to B Co and receives cash in exchange, and at the same time the parties agree that A Co will purchase back the shares at a later point in time at an agreed price. Between sale and repurchase, SPV earns income (*e.g.* receives interest on bonds) that is taxable in country A, and pays corporate income tax to country A. SPV further pays out dividends to B Co, typically at a fixed rate. Under the repo agreement used in the arrangement, B Co is entitled to keep the dividends, which economically serve as B Co's remuneration in the transaction.

Figure 3. "FTC generator" with hybrid transfer



20. For country B tax purposes, the repo is treated as a sale and a repurchase. B Co is thus treated as the owner of the SPV shares and the recipient of the dividends during the time of the repo. Country B has an indirect foreign tax credit regime that allows B Co to claim a foreign tax credit for the corporate income tax paid by SPV in country A. On the other hand, for country A tax purposes, the transaction is treated as a loan by B Co to A Co that is secured through the SPV shares. A Co is thus regarded as still being the owner of the SPV shares and as recipient of the dividends during the time of the repo. Country A applies an exemption for dividends received by B Co, or an indirect foreign tax credit regime that allows A Co to claim a tax credit for the corporate income tax paid by SPV, in any case a method that allows A Co to receive the dividends effectively tax-free. A Co further claims a deduction for the interest expenses on the deemed loan received from B Co, equal to the dividend payments.

21. The effect of this scheme is a net deduction in country A, coupled with taxation in country B, but offset by an indirect foreign tax credit for the taxes the SPV paid on the distributed profits.

Chapter 2

Policy Issues

22. As seen in the previous chapter, hybrid mismatch arrangements may be used to exploit differences in countries' tax rules and achieve results such as *(i)* the multiple deduction of the same expense in different countries, *(ii)* the deduction of a payment in the country of the payer without a corresponding inclusion in the country of the payee and *(iii)* multiple tax credits for a single amount of foreign tax paid. Hybrid mismatch arrangements therefore raise a number of tax policy issues, affecting for example tax revenue, competition, economic efficiency, transparency and fairness.

A. Tax revenue

23. International hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue. Further, the taxpayer will incur certain costs for devising and implementing these arrangements, such as costs for advice or for the formation of special purpose entities, which will generally be deductible in one of the countries involved and further reduce tax revenue.

B. Competition

24. Some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may profit from hybrid mismatch opportunities and have unintended competitive advantages compared with other businesses, such as small and medium-sized enterprises, that cannot or cannot easily use mismatch opportunities.

C. Economic efficiency

25. Where a hybrid mismatch is available, a real cross-border investment will often be more attractive than an equivalent domestic investment in the investor's country (thus affecting Capital Export Neutrality), as well as more attractive than a competing local investor's investment in the target country (thus affecting Capital Import Neutrality). In addition, hybrid mismatch arrangements may potentially contribute to financial instability through increases in leverage from tax-favoured borrowing, through increases in risk-taking (as investments which are uneconomic before tax become marginally viable after tax) and through a relative lack of transparency caused by the adoption of tax-driven structures.

D. Transparency

26. The public will be generally unaware that the effective tax regime is quite different for those taxpayers that can profit from mismatch opportunities. Even when

the public may note a low effective tax rate, they may not fully understand the underlying reasons for that.

E. Fairness

27. Fairness relates to the fact that mismatch opportunities are more readily available for taxpayers with income from capital, rather than labour. The ability of a select group of taxpayers to reduce their taxes could be perceived as unfair, thus affecting public confidence in the fairness of the tax system. This is to some extent linked with the competitive advantages hybrid mismatch opportunities may give to some businesses but not to all, as discussed above.

28. One preliminary conclusion is that hybrid mismatch arrangements that apparently comply with the letter of the laws of two countries but that achieve non-taxation in both countries, which result may not be intended by either country, generate significant policy issues. The same concern that exists in relation to distortions caused by double taxation exists in relation to unintended double non-taxation.

Chapter 3

Policy Options

29. There are in principle several domestic law options for countries concerned with hybrid mismatch arrangements.³ These policy options are briefly described below.

A. Harmonisation of domestic laws

30. One theoretical approach to deal with hybrid mismatch arrangements is the elimination of commonly exploited differences in the tax treatment of entities, instruments and transfers. As it does not seem possible to have a harmonised treatment even for the most commonly exploited differences which would eliminate the possibility for mismatches among different countries, this option is simply mentioned for the sake of completeness.

B. General anti-avoidance rules

31. General anti-avoidance rules (including judicial doctrines such as “abuse of law”, “economic substance”, “fiscal nullity”, “business purpose” or “step transactions”) can be an effective tool in addressing some hybrid mismatch arrangements, in particular 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 tend to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements.

32. As a consequence, although general anti-avoidance rules are an effective tool, they may 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

33. A number of countries have introduced rules which may directly or indirectly impact on hybrid mismatch arrangements. For example, certain countries have introduced rules that in certain cases deny the deduction of payments in cases where the same are not subject to a minimum level of taxation in the country of the

³ Although treaty-based rules may in some cases be effective, most hybrid mismatch arrangements exploit differences in domestic laws. Therefore, the impact of treaty-based provisions in these respects may be limited. The notion that different characterisations by two different countries should not result in unintentional double non-taxation is already contained to some extent in the OECD Model Tax Convention, for example as regards double non-taxation deriving from the application of different provisions of the treaty due to domestic law differences (see paragraph 32.6 of the Commentary on Article 23) or from different interpretations of the facts of the case or of the provisions of the Convention (see paragraph 4 of Article 23A of the OECD Model Tax Convention). The Committee on Fiscal Affairs is currently doing work on the other potential treaty issues that arise in the case of hybrid mismatch arrangements through its Working Party No. 1 on Tax Conventions and Related Questions.

recipient.⁴ Similarly, other countries deny companies a deduction for a finance expense where a main purpose of gaining a tax advantage in that country is established.⁵ While these provisions are not specifically aimed at deductions with no corresponding inclusion for tax purposes, they may indeed impact on them by denying the deduction at the level of the payer. In New Zealand, thin capitalisation rules requiring equity for any investments generating foreign tax credits in excess of NZD 5 million (EUR 3 million) have been effective in countering outbound foreign tax credit generator schemes.

D. Rules specifically addressing hybrid mismatch arrangements

34. A number of countries have introduced rules which specifically address certain hybrid mismatch arrangements. Pursuant to 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. Although rules under which the tax treatment in the first country depends on the tax treatment in the second country make the application of the law more complicated, rules taking into account the tax treatment in another country are not a novelty, as in principle foreign tax credit rules, subject to tax clauses, and CFC rules often do exactly that.

35. Domestic law rules which link the tax treatment of an entity, instrument or transfer in the country concerned to the tax treatment in another country appear to hold significant potential as a tool to address hybrid mismatch arrangements that are viewed as inappropriate. Chapter 4 describes these rules in more detail while Chapter 5 illustrates country experiences in applying them.

4 See for example Article 10a of the Netherlands Corporate Income Tax Act and Chapter 24 Sections 10 a – 10 e §§ of the Swedish Income Tax Law. Similar rules are contained in Article 11(1)(4) of the Austrian Corporate Income Tax Act.

5 See for example Section 441 of the UK Corporation Tax Act 2009.

Chapter 4

Rules Specifically Addressing Hybrid Mismatch Arrangements

36. A number of countries have introduced rules which specifically deny benefits arising from certain hybrid mismatch arrangements. The thrust of all these rules is to link the domestic tax treatment of an entity, instrument or transfer involving a foreign country with the tax treatment in that foreign country. At the same time, these rules also present several differences regarding their scope, mode of application, and effects. Examples of rules that have been introduced in participating countries to address multiple deduction, deduction / no inclusion, or foreign tax credit generators are summarised below.

A. Rules addressing the multiple deduction of the same expense

37. Denmark, Germany, New Zealand, the United Kingdom and the United States have rules which in certain circumstances deny the deduction of expenses which are also deductible in another country.

Denmark

38. A Danish resident taxpayer is not entitled to claim a deduction for an expense if (i) that expense is claimable under foreign tax rules against income that is not included in the computation of Danish tax, or (ii) if under the foreign tax rules, the expense is deductible against income derived by affiliated companies which is not included in the computation of Danish tax.⁶ Similar rules exist in the case of permanent establishments (PE): losses of a PE cannot be set off against other group members' profits if the loss is included in the company' income in the country of residence. The losses can only be carried forward against future profits of the PE.⁷

Germany

39. A parent company's negative income is not taken into account for purposes of the group taxation regime if the negative income is also taken into account in a foreign State in a manner corresponding with the taxation applied to the parent company under the German system.⁸ This provision prevents dual-resident companies from deducting the same loss in both Germany and another country.

6 Section 5G of the Tax Assessment Act.

7 Section 31.2 of the Corporate Tax Act.

8 Section 14.1.5 of the Corporation Tax Act.

New Zealand

40. New Zealand has dual resident company rules that prevent loss offsets from any company that is resident in New Zealand and also resident elsewhere, even if no deduction is taken in the other country.

United Kingdom

41. The United Kingdom (UK) has targeted legislation that applies where there are two deductions for tax purposes in relation to the same expense.⁹ Four conditions must be met by the avoidance scheme before the legislation will apply: *(i)* the transaction(s) are part of a “qualifying scheme” in that the transaction(s) involve the use of a hybrid entity or a hybrid instrument; *(ii)* there is a deduction or a set off against profits for a UK resident company, *(iii)* one of the main purposes of the scheme is to obtain a UK tax advantage for the company, and *(iv)* the tax advantage obtained for the company is of more than a minimal amount. Where the rule applies, HM Revenue and Customs (HMRC) can issue a notice to a company directing that the legislation applies and that the tax deduction should be disallowed for UK corporation tax purposes. HMRC operates a voluntary “clearance” process. Where it is HMRC opinion that the legislation will not apply, any clearances given are binding upon HMRC.

42. Furthermore, UK companies and UK Permanent Establishments of foreign entities cannot surrender losses to other group companies where the loss relates to an amount that is, for the purposes of non-UK tax, deductible or otherwise allowable against non-UK profits of any person.¹⁰ There are also rules which restrict the ability to group relieve losses of a dual resident investing company (*i.e.* a company that is centrally controlled and managed in the UK but also tax resident in another jurisdiction, and is not a trading company). Where a company is a dual resident investing company it cannot surrender its losses to other companies that are members of the group or other amounts available for surrender.¹¹

United States

43. Under United States law,¹² dual resident corporations are prevented from using a single economic loss once to offset income that was subject to United States tax, but not foreign tax, and a second time to offset income subject to foreign tax, but not United States tax. In 1988, the application of the legislation was extended to cover “separate units” of United States resident corporations (“domestic corporations”), in view of situations where, for example, a domestic corporation’s foreign branch or permanent establishment was allowed, under foreign law, to consolidate with the corporation’s foreign affiliate. In general, a dual consolidated loss is the net operating loss of a dual resident corporation, or the net loss attributable to a “separate unit” of a domestic corporation. A dual resident corporation is generally defined as a domestic corporation subject to the income tax of a foreign country on its worldwide income or on a residence basis. A separate unit is generally defined as a foreign branch (including permanent establishments) or an interest in an entity that is not taxable as

9 Section 244 Taxation (International and Other Provisions) Act 2010.

10 Sections 106 and 107 of the Corporation Tax Act 2010.

11 Section 109 Corporation Tax Act 2010.

12 Section 1503(d) of the Internal Revenue Code. The Internal Revenue Service (IRS) and U.S. Treasury Department issued temporary regulations under I.R.C. § 1503(d) in 1989, and final regulations in 1992. In response to subsequent developments, in particular various issues or concerns involving the interaction with the entity classification rules, the IRS and Treasury Department issued new final regulations under I.R.C. § 1503(d) in 2007 (“Dual Consolidated Loss Regulations” or “DCL Regulations”).

a corporation for U.S. tax purposes but is subject to an income tax of a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.

44. Subject to certain exceptions, the “domestic use” of a dual consolidated loss is not permitted. A domestic use occurs when a dual consolidated loss is made available to offset, directly or indirectly, the income of a “domestic affiliate”, which includes a member of a consolidated group. The primary exception to the domestic use limitation is where the taxpayer makes a “Domestic Use Election”. This election generally permits the domestic use of a dual consolidated loss if the taxpayer agrees, for a five-year certification period, not to use any portion of the dual consolidated loss to offset the income of a foreign corporation, or income attributable to certain interests in hybrid entities (a “foreign use”).¹³

B. Rules addressing the deduction of payments which are not included in the taxable income of the recipient

45. Denmark and the United Kingdom have rules which in certain cases deny the deductibility of payments that are not taxable at the level of the recipient due to a mismatch in treatment.

Denmark

46. A Danish company or a foreign company with a permanent establishment (PE) in Denmark is treated as transparent for all purposes of Danish tax law if (i) the company is disregarded for tax purposes in a foreign country, (ii) the income of the company is included in the foreign taxable income of one or more affiliated companies in the foreign country that disregards the company; (iii) the foreign affiliated companies control the company, and (iv) the foreign jurisdiction is an EU or EEA state, or has concluded a tax treaty with Denmark. In these circumstances, the company will not be entitled to a deduction for payments made to the foreign parent company since the payments are considered to be within the same legal entity.¹⁴

47. Additionally, targeting potential scenarios in which the main rule may be circumvented, the legislation provides that affiliated companies in other countries may also be treated as transparent for Danish tax purposes if they are treated as transparent for tax purposes in the residence country of the company that controls both the Danish company and the other affiliated companies. The consequence is that the Danish company will not be entitled to a deduction for payments made to these affiliated companies, as they would likewise be considered to be within the same legal entity. This rule does not apply if the affiliated entity is resident in an EU/EEA or a treaty state other than the residence state of the parent company. However, as from 2011, the rule applies if the affiliated entity in the EU/EEA or treaty state is not the beneficial owner of the payment.

13 A foreign use is deemed to occur when any portion of the deduction or loss taken into account in computing a dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognised as income or gain under such laws and that is under U.S. tax principles an item of a foreign corporation or certain interests in hybrid entities. A foreign use may also occur indirectly. An item of deduction or loss is made available indirectly if it is 1) taken into account as a deduction or loss for foreign tax purposes but does not give rise to a corresponding item of income or gain for U.S. tax purposes; and 2) the item of deduction or loss described in the first condition has the effect of making an item of deduction or loss composing the dual consolidated loss available for a foreign use. An exception applies for certain items that are not incurred with a principal purpose of avoiding section 1503(d) and that are incurred in the ordinary course of business. Items incurred as the result of an instrument that is treated as debt for foreign tax purposes and equity for U.S. tax purposes (i.e. a hybrid instrument) shall be deemed to have been incurred with a principal purpose of avoiding section 1503(d).

14 Section 2A to the Danish Corporate Tax Act.

48. Denmark has also introduced domestic legislation to deal with cases of deduction/no inclusion through the use of hybrid financial instruments.¹⁵ The legislation applies where: (i) a fully taxable Danish company, or a foreign company with a PE or immovable property in Denmark is “indebted or similarly obligated”, (ii) the indebtedness or similar obligation is owed to a non-resident individual or non-resident company who has “decisive influence” over the Danish debtor company or if the companies are considered to be in a “group of companies”, (iii) the instrument in question is considered to be debt under Danish Tax law, (iv) the instrument is treated as equity/paid-in capital under the tax legislation of the investor’s residence country. If these conditions are met, the instrument is considered to be equity for purposes of Danish income tax computation. One of the results of the reclassification is that any interest expense or capital loss on the debt would not be deductible. Another consequence of this reclassification is that the withholding tax on the payment would be at the rate applicable to dividends as opposed to the rate applicable to interest and capital gains.

49. Further, specific legislation has been introduced to deal with cases of deduction/no inclusion through entities which are treated as fiscally transparent for Danish tax purposes but as separate taxable entities for foreign tax purposes.¹⁶ The legislation applies to Danish registered branches of foreign entities and tax-transparent entities that are organised in Denmark, have their registered seat in Denmark, or have their effective seat of management in Denmark where (i) more than 50% (votes or capital interests) of the direct partners/owners are residents in foreign states, and (ii) those states consider the entity to be a separate taxable entity or do not have a tax treaty with Denmark. In these circumstances, the entity will be subject to the same tax treatment as Danish resident companies and distributions from the entity will be treated as a dividend distribution for tax purposes and consequently could be subject to withholding tax.

United Kingdom

50. The United Kingdom has specific legislation targeting cases where in respect of a payment there is a deduction for tax purposes in the UK but no corresponding taxable receipt in relation to that payment. The legislation applies when (i) the transaction(s) are part of a “qualifying scheme” in that the transaction(s) involve the use of a hybrid entity or a hybrid instrument, (ii) there is a deduction or a set off against profits for a UK resident company, (iii) one of the main purposes of the scheme is to obtain a UK tax advantage for the company and (iv) the tax advantage obtained for the company is of more than a minimal amount. Cases where the payment received is not taxable because the recipient is not liable to tax under the tax law of that jurisdiction, or is not subject to tax because of an exemption provided for in the tax law of any other jurisdiction, are expressly carved out. Where the rule applies, HM Revenue and Customs can issue a notice to a company directing that the legislation applies and that the tax deduction should be disallowed for UK corporation tax purposes.

C. Rules addressing the non-inclusion of income which is deductible at the level of the payer

51. Austria, Denmark, Germany, Italy, New Zealand and the United Kingdom have introduced rules that deny the exemption of income which is deductible in the other

15 Section 2B to the Danish Corporate Tax Act.

16 Section 2C to the Danish Corporate Tax Act.

country. This latter approach has also been agreed upon by the EU Code of Conduct Group (Business Taxation) in relation to hybrid instruments.¹⁷

Austria

52. Income derived from instruments which would qualify as an equity investment for Austrian tax purposes are exempt under the Austrian participation exemption regime provided it does not qualify as a tax deductible expense for the payor.

Denmark

53. Dividends received by a Danish parent company are no longer tax exempt if the subsidiary is able to claim a tax deduction for the dividends.¹⁸ The rule does not apply if the dividends are covered by the EC Parent-Subsidiary Directive. As from 2011, the rule also applies if the deduction has been made in a lower tier subsidiary and the dividend has not been taxed in a subsidiary inserted between the subsidiary claiming the deduction and the Danish parent company.

Germany

54. Profit distributions are generally tax-exempt for the recipient company. However, the tax exemption does not apply to constructive dividends (*verdeckte Gewinnausschüttungen*) if such dividends were deductible expenses for the paying company.¹⁹

Italy

55. According to Italian law, profits distributed by non-resident entities are 95% exempt for tax purposes only if the following conditions are met: (i) the profits are fully linked to the economic results of the issuer or of any other companies which are part of the same group or of the specific business in relation to which financial instruments have been issued; and (ii) the profits are not deductible in the foreign country where the issuer is resident.²⁰ The condition that the income distributed is non-deductible in the issuer's jurisdiction must be proved by a declaration from the issuer itself or by other appropriate evidence.

New Zealand

56. Dividends from foreign companies where the New Zealand resident holds more than 10% of the shareholding are exempt from income tax unless they are dividends from a fixed rate share or if they are deductible in the foreign country.

17 The EU Code of Conduct Group (Business Taxation) "agreed that a problem arises when the Member State of the corporate taxpayer paying interest allows its deduction from the tax base, whereas the Member State of the corporate taxpayer which receives the income considers it as a tax exempted dividend income. In that case, such income would remain untaxed in both Member States". To avoid these mismatches, the Group agreed that "... in as far as payments under a hybrid loan arrangement are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption". However, as there was no agreement regarding the legal form through which this solution should be implemented, it was agreed that further work was needed in this respect and decided to come back subsequently (see the Report of the Code of Conduct group (Business Taxation) to the ECOFIN Council of 8 June 2010, No. 1033/10).

18 Section 13 of the Corporate Tax Act.

19 Section 8b (1) of the Corporation Tax Act.

20 See Articles 89.3 and 44.2.a of the Italian Consolidated Italian Income Tax Code.

United Kingdom

57. The UK has specific legislation which can apply to certain receipts that would, under normal circumstances, not be taxable receipts for the purposes of UK corporation tax. The legislation applies where four conditions are met, namely that (i) there is a scheme that makes or imposes a provision between a company and another person by means of a transaction or series of transactions, (ii) the other person makes a payment to the company that is a qualifying payment, *i.e.* a contribution of capital to the company, (iii) there is an amount that is a deductible amount in relation to the payment that is not set against income arising from the scheme, and the payment is not treated as income or gains, for the purposes of UK corporation tax, arising to any UK resident company,²¹ and (iv) the company and the other person expected that a benefit would arise as a result of the payment not being a taxable receipt.²² Where these conditions are met, HMRC can issue a notice to a company directing that the legislation applies and that the exemption should be disallowed for UK corporation tax purposes.

D. Rules addressing abusive foreign tax credit transactions

58. Italy, the United Kingdom and the United States have introduced rules aimed at curbing abusive foreign tax credit transactions that inappropriately exploit differences in countries' laws. Although Canada believes that abusive foreign tax credit schemes can be successfully challenged under its existing general anti-avoidance rule, the magnitude of the problem warranted greater assurance through specific legislative action. In its Budget 2010, the Canadian government proposed measures that will deny claims for foreign tax credit in circumstances in which the income tax law of the jurisdiction levying the foreign income tax considers the Canadian taxpayer to own a lesser interest in the foreign special purpose entity than the Canadian taxpayer is considered to own for the purposes of Canada's tax law.

Italy

59. Italian tax law provides a specific rule which can be used to tackle foreign tax credit generator schemes.²³ Specifically, in the case of Repurchase agreement (Repo) and Securities lending or other transactions that yield similar effects, the Italian taxpayer (borrower) receiving dividends, interests or other proceeds is entitled to a foreign tax credit, only if these benefits would have been granted to the beneficial owner (lender) of the said income flows (*i.e.* if the lender is subject to the same tax regime of the borrower). As a consequence, the borrower can claim a foreign tax credit only if the lender is an Italian entity or a foreign entity with a permanent establishment in Italy.

United Kingdom

60. The United Kingdom has introduced legislation targeting foreign tax credit generators where the credit results from a scheme or arrangement which has the obtaining of credit relief as one of its main purposes and the scheme falls within one of five specified circumstances, namely that: (i) the foreign tax is not properly attributable to the source from which the income or gain is derived, (ii) the payer of the foreign tax

21 There are also conditions that give other UK legislation priority in taxing the receipt.

22 Sections 249 to 254 of the Taxation (International and Other Provisions) Act 2010.

23 This rule is focused on dividend exemption only and is contained Sub Art. 2, Paragraph 2, of the Legislative Decree n. 461/1997. The provision was amended on 12 April 2009 to expressly tackle schemes seeking to obtain foreign tax credits in Italy and in a foreign country, where only one withholding tax was suffered.

or deemed foreign tax, taken together with all other parties to the scheme or arrangement, has not suffered the full economic cost of the foreign tax against the income or gain against which relief is claimed, (iii) a claim, election or other arrangement could have been made by any person under the law of any territory or under any arrangements made in relation to any other territory, which would have reduced the amount of credit for foreign tax (alternatively, a claim, election or arrangement was made that had the effect of increasing the amount of credit for foreign tax), (iv) the foreign tax credit given as a result of the scheme or arrangement reduces the amount of tax payable to an amount less than would have been payable if the transactions making up the scheme had never taken place, (v) a source of income subject to foreign tax has been acquired wholly or partly as consideration for a tax-deductible payment. Where the trigger conditions are met, HMRC may issue a notice directing that the legislation applies. The notice may also set out HMRC's view of the just and reasonable amount of credit to be given for foreign tax.

United States

61. Final and temporary regulations (the "temporary regulations") as well as new proposed regulations relating to the amount of taxes paid for purposes of the foreign tax credit were issued on 16 July 2008.²⁴ The temporary regulations retain the general rule in the existing regulations that a taxpayer need not alter its form of doing business or the form of any transaction in order to reduce its foreign tax liability. However, they also address cases where the foreign payment is attributable to a "structured passive investment arrangement", which in general terms is an arrangement to exploit differences between U.S. and foreign law in order to permit a person to claim a foreign tax credit for the purported foreign tax payments while also allowing the counterparty to claim a duplicative foreign tax benefit. The person claiming foreign tax credits and the counterparty share the cost of the purported foreign tax payments through the pricing of the arrangement. The temporary regulations treat foreign payments attributable to such arrangements as non-compulsory payments and, thus, disallow foreign tax credits for such amounts. The final foreign tax credit regulations (the "final regulations") effective on 18 July 2011, retain the basic approach and structure of the 2008 temporary regulations. Thus, the final regulations provide that amounts paid to a foreign taxing authority that are attributable to a structured passive investment arrangement are not treated as an amount of tax paid for purposes of the foreign tax credit.

62. Further, there are provisions which address situations where foreign income taxes have been separated from the related income. These provisions suspend credits until the income related to those credits is included in U.S. taxable income.²⁵ Finally, there are provisions denying a foreign tax credit for the disqualified portion of any foreign income tax paid or accrued in connection with a so-called "covered asset acquisition".²⁶ In general terms these are transactions that create a difference between the U.S. tax base and the foreign tax base (due primarily to differences in the tax basis of the acquired assets), and may generate foreign tax credits without a related income inclusion for U.S. tax purposes.

24 Issued under section 901 of the I.R.C. - Final and temporary regulations: TD 9416, Federal Register Vol. 73 No. 137 of 16 July 2008, pp. 40727-40738.

25 Section 909 of the I.R.C.

26 Section 901(m) of the I.R.C.

Chapter 5

Country Experience with the Application of Rules Specifically Addressing Hybrid Mismatch Arrangements

63. This chapter shows that a number of countries have introduced rules which expressly deny benefits from hybrid mismatch arrangements. In most cases these rules address specific instances aimed at obtaining certain multiple deductions, deduction/no inclusion effects, or foreign tax credit generators, while only a few countries have a set of rules addressing the issues raised by hybrid mismatch arrangements on a comprehensive basis.

64. The experience of countries that have introduced rules expressly denying the benefits derived from hybrid mismatch arrangements has overall been positive. In general, countries have found that these rules are effective and have impacted on taxpayers exploiting mismatches in the tax treatment of instruments, entities or transfers across different countries. For example, Italy and the United States found evidence showing that the exploitation of certain mismatches aimed at generating foreign tax credits has stopped since the introduction of the rules denying benefits in those cases. The United Kingdom reported that the use of wholly abusive schemes to obtain double deductions has decreased sharply since the introduction of its targeted legislation and the restrictions on the group relief provisions have been effective at stopping the double claim of losses and other reliefs.

65. Countries have also noticed that the introduction of these rules may act not only as a deterrent for taxpayers that want to be compliant, but also eliminate the uncertainty that would otherwise arise regarding the tax treatment of these arrangements. For example, in the last 10 years New Zealand has had only one case on the application of its rules preventing double deductions in the case of dual resident companies.

66. Country experiences also show that the application of the rules needs to be constantly monitored. Revenue bodies have noticed that arrangements may become more elaborate after the introduction of specific rules denying benefits in the case of hybrid mismatch arrangements. In some cases it has been necessary to amend the rules to ensure that they are not circumvented. For instance, in 2011 Denmark amended its existing rules regarding the denial of the deduction for payments which are not included in the taxable income of the recipient, as taxpayers tried to circumvent the rules by interposing companies in a EU/EEA or treaty state. To counter these arrangements, Denmark introduced a new rule under which interest and royalty payments to companies in the EU/EEA or a treaty state are only deductible if the latter company is the beneficial owner of the payment. Similarly, audit activities carried out in Italy have revealed the use of schemes that seek to circumvent the rules denying benefits in the case of hybrid mismatch arrangements aimed at achieving a deduction/no inclusion effects through the interposition of entities resident in third countries.

67. Countries have also pointed out that the application of these rules makes it necessary to refer to the corresponding foreign tax treatment and this may in some cases create difficulties. The increasing focus on international cooperation in tax matters will certainly reduce this difficulty as exchange of information and higher levels of interaction between competent authorities become more widespread. In some

cases, country rules require the taxpayer to provide evidence of the tax treatment in the other country. For instance, in the United States, if the taxpayer wants to use a foreign loss under the dual consolidated loss regulations, it has to certify that no foreign use of the loss has or will occur in the foreign jurisdiction and no subsequent triggering event has occurred that would cause a recapture of prior losses. In the case of the Italian participation exemption legislation the taxpayer has to provide a declaration of the issuer of the instrument or any other relevant elements such as tax returns, other documentation for tax purposes, certificate supplied by foreign tax authorities or institutions recognised by public authorities, proving that the payment was not deductible in the other jurisdiction.

68. As regards the mode of application of these rules, most of them apply directly when certain conditions are met, while in some cases, as in the case of the United Kingdom rules, it is necessary for the tax administration to issue a notice to the taxpayer stating that the legislation applies. The notice needs to indicate (i) the company to whom it is issued, (ii) the period to which it relates, (iii) the transactions to which the notice applies, and (iv) HMRC's view of the implications of the notice for the taxpayer's liability to tax. Once a notice has been issued, the company must consider what effect the legislation has on their tax liability in the same way as they consider any other relevant tax legislation.

69. Finally, it is worth mentioning that in principle operating rules that link the tax treatment in one country to the tax treatment in another country may also require introducing a "tie-breaker" test to solve issues that may arise when both countries' tax laws look at the treatment in the respective other country, *e.g.* if in a deduction / no inclusion case involving an hybrid instrument, the country of the payer denies the deduction if the income is not included in the taxable income of the recipient and the country of the recipient denies the exemption if the payment is deductible in the country of the payer. Country rules linking the domestic tax treatment to the foreign tax treatment do not generally contain a tie-breaker test for cases where the other country involved has similar rules. Although the matter may become more relevant as more countries introduce similar rules, it appears that to date this has not caused major issues. This is likely due to the fact that only sophisticated taxpayers engage in such arrangements and they generally avoid using arrangements where they see a risk of double taxation.

Conclusions and Recommendations

Countries' strategies have to operate within the broader context of their tax system, administrative practice and culture. It is up to each country to decide how to approach the issues addressed in this report and what strategies would be the most appropriate in the context of, and the most consistent with, its rules and framework. At the same time, in a world where economies are increasingly integrated, it is essential to consider how tax systems interact with each other. This is relevant not only to eliminate obstacles to cross-border trade and investment, but also to limit the scope for unintended non-taxation. It is against this background that this report reaches the following conclusions and recommendations.

Conclusions

- a) Hybrid mismatch arrangements that arguably comply with the letter of the laws of two countries but that achieve non-taxation in both countries, which result may not be intended by either country, generate significant policy issues in terms of tax revenue, competition, economic efficiency, fairness and transparency.
- b) The same concern that exists in relation to distortions caused by double taxation exists in relation to unintended double non-taxation.
- c) Specific and targeted rules which link the tax treatment in the country concerned to the tax treatment in another country in appropriate situations hold significant potential to address certain hybrid mismatch arrangements and have recently been introduced by a number of countries.
- d) Countries' experience in relation to the design, application and effects of specific and targeted rules denying benefits in the case of hybrid mismatch arrangements is positive. The application of the rules needs however to be constantly monitored to ensure that the rules apply in appropriate circumstances and are not circumvented through the use of even more complex arrangements.

Recommendations

Based on these conclusions, and building on the work of the Aggressive Tax Planning Steering Group, the OECD's Committee on Fiscal Affairs recommends countries to:

- a) Consider introducing or revising specific and targeted rules denying benefits in the case of certain hybrid mismatch arrangements;
- b) Continue sharing relevant intelligence on hybrid mismatch arrangements, the deterrence, detection and response strategies used, and monitor their effectiveness;
- c) Consider introducing or the revising disclosure initiatives targeted at certain hybrid mismatch arrangements.

Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues

Aggressive Tax Planning is an increasing source of concern for many governments.

This report describes the most common types of hybrid mismatch arrangements (i.e. arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries) and the effects they aim to achieve. It summarises the tax policy issues raised by these arrangements and describes the policy options to address them, with a focus on domestic law rules which deny benefits in the case of hybrid mismatch arrangements and countries' experiences regarding their application.

The report concludes that the same concern that exists in relation to distortions caused by double taxation exists in relation to unintended double non-taxation and recommends a number of actions to be undertaken.

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Further reading

Corporate Loss Utilisation through Aggressive Tax Planning (2011)

Tackling Aggressive Tax Planning through Improved Transparency and Disclosure (2011)

Addressing Tax risks Involving Bank Losses (2010)

www.oecd.org/tax