Analysis

# Hybrids: the UK and OECD proposals


## Speed read

**Many debt planning arrangements exploit mismatches between tax regimes. A typical hybrid instrument is debt for the payer but equity for the recipient. A hybrid entity is opaque in one jurisdiction but transparent in the other. The OECD proposals counteract this by either denying the deduction or taxing the receipt. The UK plans to introduce the rules by 2017. They contain no motive test and the thresholds for applications are worryingly low. Issues relating to CFC inclusion and hybrid regulatory capital remain unsolved. Companies should act now to refinance, recognising that fewer and fewer tax effective structures for cross-border debt remain.**



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The three main areas of focus of the OECD BEPS exercise are coherence, substance and transparency. The hybrid proposals primarily address coherence; namely, base erosion which relies on mismatches or 'black holes' between different tax systems. The first major economy to propose the domestic introduction of the OECD hybrid rules is the UK. This article outlines these rules and the reasons for them, looks at their likely impact and highlights the shifts they will generate in the conventional thinking of MNEs and their advisers.

### The problem

The OECD/G20 final report of 2015 *Neutralising the effects of hybrid mismatch arrangements* ('the report') neatly summarises why the proposals are needed:

> 'Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangement are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.' (The report, page 11).

A 'hybrid mismatch' arrangement is defined in the report as an arrangement designed to exploit asymmetries between different tax jurisdictions through the use of a hybrid entity or a hybrid instrument.

A 'hybrid entity' is one which is or may be treated differently under the rules of two different tax jurisdictions. The commonest example is an entity which one jurisdiction treats as opaque for tax purposes (namely, as a taxable person, such as a company) and which another jurisdiction treats as transparent (for instance, a partnership, the profits of which are taxable in the hands of its members). A 'hybrid instrument' is one characterised differently by two tax jurisdictions – usually, as debt in one jurisdiction and equity in the other.

Such structures are typically used in debt planning within an MNE to achieve a tax deduction for financing costs without a corresponding taxable receipt, or to achieve a tax deduction in more than one jurisdiction. This exploits the lack of coherence between tax jurisdictions as to how they regard entities and instruments; and it is one of the most significant factors contributing to the erosion of an MNE's taxable base – the base erosion (BE) part of BEPS. Unlike the profit shifting (PS) part of BEPS, such planning requires relatively little in the way of substance (and, therefore, in the way of cost), since debt is by its nature more easily managed and dealt with than a group's underlying supply chain. For that reason, debt planning through hybrid structures represents a significant threat to the global tax base, though it is not always clear which country's tax base bears that cost. (See examples on opposite page.)

### The OECD recommendations

Although they also deal with more complex situations (such as 'reverse hybrids'; see below), the OECD proposals contained in the report primarily address two structures. The first is where hybrid entities or instruments produce a tax deduction in two jurisdictions (a 'double deduction (DD) outcome'). The second is where they produce a tax deduction in one jurisdiction with no corresponding receipt as taxable income in any jurisdiction (a 'deduction/no inclusion (D/NI) outcome').

> Setting the thresholds as proposed effectively assumes that the mischief is hybridity itself

The bedrock of the OECD proposals is a set of 'linking rules', which essentially necessitate a comparison between the tax treatment of the hybrid payments in the relevant jurisdictions. Assume a hybrid mismatch which involves two jurisdictions. Under the proposals, the primary rule ('rule A') will determine which of the two jurisdictions may disallow the deduction. If that jurisdiction has not implemented hybrid mismatch rules, the other jurisdiction will be able to invoke the secondary defensive rule ('rule B') to counteract the mismatch by denying the deduction or taxing the corresponding receipt.

In a UK context, once the UK introduces the new rules, this will have the following effects:

- Where a UK entity makes a payment as part of a hybrid arrangement, rule A will deny a deduction to the extent that it gives rise to a D/NI outcome.
- Where a UK entity receives a payment as part of an arrangement with a D/NI outcome, rule B will operate to tax the payment in the UK, if the jurisdiction of the payor does not apply rule A.
- Where a UK entity is an investor in a hybrid entity that is treated as transparent for UK tax purposes, rule A will deny a deduction for payments that give rise to a DD outcome.
- Where a UK entity is a hybrid entity making a payment which gives rise to a DD outcome, rule B will deny a deduction if the investor jurisdiction does not

apply rule A.

Where a hybrid mismatch arises by virtue of both a hybrid instrument and a hybrid entity, the rules will counteract the hybrid instrument mismatch first.

The report further recommends the introduction of rules to address 'reverse hybrids', namely entities regarded as transparent where they are located and opaque at investor level. The UK will implement this proposal by treating limited liability partnerships which are reverse hybrids as companies subject to corporation tax.

The UK tax system already incorporates loss relief restrictions for dual resident investment companies (being entities potentially giving rise to a DD outcome). Under the proposals, all dual resident companies will be denied all debt deductions, unless they are set against income that is subject to dual inclusion or the deductions are permitted under the terms of a tax treaty competent authority agreement. The government has also indicated its preference to determine company residence for treaty purposes through competent authority agreement, and that it will continue to negotiate treaty tie-breaker provisions in this way.

## The proposals do not apply to tax rate arbitrage

### Timing

The UK has committed to implementing the proposals contained in the report. In December 2014, a consultation process was launched by HM Treasury and HMRC. The responses were due to have been published this summer, but perhaps they will appear as part of an update on the proposals in the Autumn Statement on 25 November. Draft legislation is likely to be the subject of consultations during 2016, with implementation taking effect from 1 January 2017. In line with the report, it appears unlikely that there will be any 'grandfathering' of structures in place at commencement.

### Some observations

In 2014, I attended various meetings at the OECD with a small number of other advisory firms to discuss the proposals and present views to country delegates. The main areas of concern which were expressed then remain relevant to the UK proposals, and are as follows:

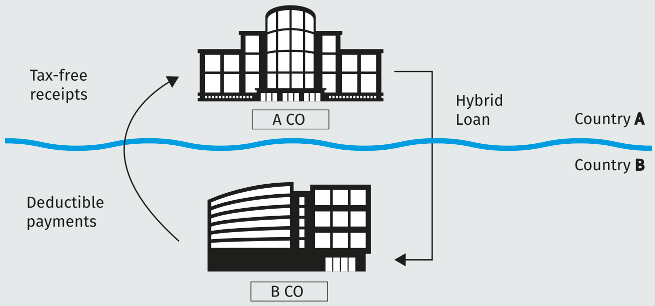
#### No motive test

The UK already has anti-hybrid rules, being the arbitrage legislation introduced in 2005. The most significant limitation on the effectiveness of those rules in practice has been that they apply only where the main purpose of an arrangement is obtaining a UK tax advantage. If a borrower can show that the structure does not produce a higher UK gearing than would have resulted from a non-arbitrage structure, the rules do not apply. This is the basis on which several UK/US debt structures, such as 'Tower' structures, have on occasion been found to be effective. The OECD proposals, on the other hand, contain no motive test and apply automatically. Crucially, the issue is the global tax base, in that there is no need to establish which jurisdiction has lost tax revenue as a result of the hybrid arrangement. This will undoubtedly make the rules easier to identify, apply and enforce, but makes it critical that they are precisely and carefully delineated.

### Examples

#### A: Hybrid instrument

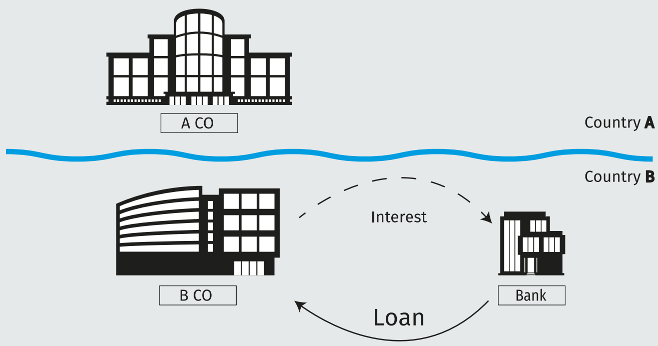
A Co lends money to its subsidiary B Co. Under the loan, payments of interest and principal are subordinated to ordinary creditors of B Co, and can be suspended if B Co fails certain solvency criteria. Country B treats the loan as debt; however, in view of its equity-like terms, Country A treats it as equity. Payments on the loan are tax-deductible interest for B Co. However, Country A regards the payments as dividends and, if Country A exempts such dividends, the receipts are not assessable to tax.




#### B: Hybrid entity

In the example above, assume the debt is plain vanilla. Country B treats B Co as a company and therefore as a taxable entity. Country A, however, treats B Co as a branch – legally, as a part of A Co. Country A might, for instance, be the US, which allows B Co to 'check the box' to elect to be treated as a branch of A Co. Country B regards B Co as paying deductible interest, but Country A disregards the payment as effectively made by an entity to itself.

#### C: Double deduction




In example B above, B Co pays interest on a loan to a third party bank. Country B grants deductions to B Co for the interest payments. However, since Country A regards B Co as a branch of A Co, A Co can also claim deductions for the same interest payments in Country A.

#### Thresholds

Perhaps the main area of concern is that, given the absence of any motive test, the thresholds for application are too broadly drawn. With some exceptions, the rules apply to hybrid arrangements which are either between 'related parties' or are 'structured arrangements'. Two parties are related if there is a common equity or voting interest of at least 25%, or they are under common control. A structured arrangement is one where it is reasonable to assume that the hybrid mismatch is priced into the terms of the arrangement, or the arrangement has been designed to produce a hybrid mismatch.

Given the basic aims of the OECD's BEPS project, these thresholds set the bar too low. If the mischief is manipulation of the taxable base by MNEs, why not restrict the rules to entities under common control? Setting the thresholds as proposed effectively assumes that the mischief is hybridity itself.

### Linking rules

In practice, the proposals require each party to a hybrid arrangement to have knowledge of the other's tax position, which will almost always be in another jurisdiction. The greatest difficulties will lie in establishing whether a payment which would otherwise be deductible is included in the ordinary income of the payee for tax purposes, which is necessary to avoid a D/NI outcome. In many hybrid arrangements, the answer will be known to the parties. But what of a hybrid instrument which is widely held and comes to be owned as to 25% by a particular investor group? Or a 'structured' arrangement which again is held by many investors, often through nominee accounts?

> [For some MNEs] the hybrid proposals will begin to make the chasing of tax-driven debt structures feel like a zero sum game

It is worth observing, as did the OECD's 2012 report on hybrids, that there are precedents for effectively requiring knowledge of another party's tax regime and position. Controlled foreign corporation (CFC) rules, foreign tax credit rules, and 'subject to tax' clauses can all raise similar issues. Perhaps the real concern here is workability, given the priority of rules A and B. In practice, while any debt issuer will know whether the payments on its debt are or are not deductible, it may not know how each payee is treated. That might point to a different priority, with payments on hybrid instruments which are deductible flagged as necessarily taxable on receipt.

### CFC inclusion

What if a receipt under a hybrid arrangement is not assessable as ordinary income of the payee, but is effectively taxed on owners of the payee under CFC rules, such as those applying in the UK? In principle, such a charge should 'frank' the payment and negate any D/NI outcome. The report leaves it open to countries to make their own policy decisions on this point. The UK consultation document of December 2014 seeks views, but the factors which are identified as 'requiring consideration' imply that any CFC inclusion is likely to be tightly drawn and to place a heavy burden of proof on the taxpayer.

### Hybrid regulatory capital

The regulatory capital regimes for banks are complex, but in practice may incentivise banks to raise capital in hybrid form, including within a group. Similar issues arise within the insurance sector. While the UK proposals present various options for consultation, this will prove to be a very important and difficult issue for the financial sector, given its importance in the UK.

## Exclusions

### Timing differences

Some debt structures rely on one jurisdiction (such as the UK) allowing a deduction on an accruals basis, with the payee being taxable only on receipt. This is not within the proposals, unless the timing mismatch is likely to exceed five years.

### Special status entities

The rules should not apply where the mismatch arises only because the payee has a special tax status; for instance, a pension fund, unit trust or charity.

### Deemed deduction for capital

The rules will not apply simply because a jurisdiction (such as Belgium or Italy) provides a notional interest deduction for equity capital.

## Adjust your set

At the risk of stating the blindingly obvious, UK groups need to review their financing arrangements and, if necessary, refinance before 2017 if they have hybrid arrangements which are likely to be counteracted.

Those considering, as an alternative, placing debt in a CFC which qualifies for the total or partial finance company exemption under the UK rules should take care. Supplementary guidance published by HMRC in November 2014 indicates that if this is done to replace, say, a 'Tower' structure in the expectation that it would not be effective following the OECD changes, then HMRC is likely to regard the 'purpose' test under the CFC provisions as denying exemption.

Some tax-effective debt structures may survive. The proposals do not, for instance, apply to tax rate arbitrage; namely, placing a taxable receipt in a low-tax jurisdiction. Therefore, a UK bidding vehicle may still be effectively financed via, say, a Maltese subsidiary established by a non-UK bidder.

Doubtless for some MNEs, debt planning will prove too ingrained a habit to break. For others, though, the hybrid proposals will begin to make the chasing of tax-driven debt structures feel like a zero sum game. ■