The BEPS Work on Hybrid Mismatches – Selected Issues

by

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I. Introduction

The BEPS work on hybrid mismatches has led to the by far longest 2015 Final Report[2] (hereafter Final Hybrids Report or Report). It contains about 450 pages, compared to a total of only 1,500 pages for the reports on the other 14 actions altogether.

Readers of this text either know the entire Report including all of its proposed domestic "linking rules" and definitions, the amendment of the OECD Model Treaty and the 80 comprehensive examples – or are not interested in so many details anyway.

Firstly, this contribution deals with some general thoughts on peculiarities of part I of the hybrids project which relates to the recommendations for do-

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1 The original speech's form was maintained, but minor adjustments and additions were made.

2 OECD (2015), Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (hereafter: OECD, BEPS Action 2 Report). On the compatibility of the (preceding) 2014 deliverable on BEPS Action 2 with non-discrimination provisions, see RUST, BEPS Action 2: 2014 Deliverable – Neutralising the Effects of Hybrid Mismatch Arrangements and its Compatibility with the Non-discrimination Provisions in Tax Treaties and the Treaty on the Functioning of the European Union, p. 308 et seqq.

mestic law. Part II with the proposed new paragraph 2 of article 1 of the OECD Model will not be discussed.

Secondly, this contribution to the conference was, as Robert Danon expressly requested, prepared with special consideration from a German perspective. Hence, some practical experience made in Germany over the last couple of years with "linking rules" will be presented.

In German tax practice, they are also known as the "corresponding principle". German experience confirms that the Report is right when it states at the outset that "'linking rules' make the application of domestic law more complicated".[3] But then the Report simply refers to the 2012 Hybrids Report[4] which "noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses and controlled foreign company (CFC) rules often do exactly that."[5] German experience dramatically shows though that drafting and applying "linking rules" is far more complex and demanding.

Thirdly, to illustrate the challenges ahead of us when it comes to the implementation of the Final Hybrids Report's recommendations into domestic tax law, some observations on the Report's examples part will be made.

II. General remarks on hybrid mismatches

As an introduction, it is apparent that a lot of tax planning relied on differences between the tax systems of two or more countries. Purely domestic businesses were often not able to use such planning techniques. The 2012 Hybrids Report already concluded that hybrid mismatch arrangements have a negative impact on competition, efficiency, transparency and fairness.[6] It seems fair to say that hybrid mismatches were indeed one of the key drivers of the whole BEPS project. Expressions like "hybrid instruments" and "hybrid entities" have a negative connotation and thereby a powerful sound in the political arena.

However, there are two difficulties.

3 Ibid, Introduction to Part I, p. 15, m.no. 2.
4 OECD (2012), Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (hereafter: OECD, Hybrid Mismatch Arrangements).
5 OECD, BEPS Action 2 Report (n. 2), m.no. 2.
6 OECD, Hybrid Mismatch Arrangements (n. 4), p. 25.

Firstly, hybrid mismatches are not always the result of efficient tax planning but occur rather accidentally sometimes.

And secondly, combatting the result of hybrid tax planning does not fit particularly well into the overall objective of the BEPS project to "ensure that profits are taxed where economic activities take place and value is created."[7]

The Final Hybrids Report does not even try to align its recommendations with this objective. Instead, the Report relies on mechanical rules which allow or require one or the other country, as the case may be, to tax an extra portion of profit. Such profit has, however, not been made in that country if one applies its tax system in its entirety and the ability-to-pay principle on the respective taxpayer.

The Report openly admits that "it is often difficult to determine unequivocally which individual country has lost tax revenue under the arrangement."[8] – One might even put it this way: "It is often *impossible* to determine which country has lost tax revenue, because no country has." The Report, in this regard, simply refers to the 2012 Hybrids Report and its conclusion that "the collective tax base of countries is put at risk".[9] In doing so, the Final Hybrids Report fails to explain what a "collective tax base" of sovereign and completely independent tax systems might be.

In fact, in most scenarios dealt with in the Report, both countries collect exactly the amount of tax which is due not only under the wording of the respective tax laws, but also under their spirit.

The Report does not attempt to propose an equitable solution to this fundamental issue. The recommended "linking rules" lack an overarching and convincing principle. Such principle might be helpful when it comes to the application of the "linking rules" in borderline cases. Additionally, due to a missing principle the recommendations are one-sided in order to avoid double non-taxation or double deductions. They do not address the issue of unrelieved double taxation if <u>that</u> is the result of a mismatch between two countries' tax systems.

The actual recommendations are *six linking rules* for identified different hybrid scenarios, which lead to either *deduction / no inclusion* or *double*

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7 OECD, BEPS Action 2 Report (n. 2), p. 3 (foreword).
8 Ibid, p. 15, m.no. 2.
9 Ibid, p. 15, m.no. 2.

deduction outcomes. The rules are divided into so-called primary rules and defensive rules, and they are accompanied by three recommendations which contain several *definitions* as well as two further *specific recommendations* for the tax treatment of financial instruments and reverse hybrids.

Finally, recommendation 9 lists some *design principles*.[10] These principles are aimed at helping countries introduce the hybrid mismatch rules in a co-ordinated manner with regard to content, interpretation and timing. Even by itself these few tasks are more than demanding for countries. Is it realistic that policymakers and taxation committees of parliaments will read and completely understand the principles with all their ramifications? And even if so, would sovereign parliaments indeed strive for implementation co-ordination with regard to timing? How would this hold up in practice?

Considering the design principles themselves, the Report claims that its rules have been designed to maximise the outcomes set out in recommendation 9.1 of the Report's chapter 9.[11]

Can we expect that the final domestic rules in all countries will also meet these expectations? For the following main reasons, slight doubts may arise:

The Report only describes the rules as regards their prerequisites and their desired legal results. However, they are not drafted in a form which would allow legislators to just copy/paste them. The Report does not provide legal language for them. Also, they cannot be implemented by use of a "multilateral instrument". Hence, each legislator must find a reasonable wording for the domestic law provisions which ensures that they are workable in the given context of the respective tax system.

If one presumes that there are good reasons for the Report to recommend six different rules for six identified hybrid scenarios one may conclude that in domestic tax law, too, it will not be possible to draft a *one-fits-all* rule. Is it realistic that legislators all over the world are going to introduce six respective domestic rules in a co-ordinated way? Is that realistic when the Report needs 15 pages for the summary of all twelve recommendations, 130 pages of detailed explanation and description and another 280 pages of examples "to explain the operation of the rules in further detail"?

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10 Ibid, p. 93 et seqq.
11 Ibid.

The Report states: "Implementation therefore becomes key at this stage."[12] There may be more truth in that statement than intended by its authors…

At this point of the contribution, it is not intended to discuss details of the recommended rules. However, one issue requires to be stressed in a more general way. The Report recommends the rules to apply "automatically" to a hybrid mismatch arrangement, "if it gives rise to a mismatch in tax outcomes that can be attributed to the hybrid element in the arrangement."[13] There are at least two serious issues with this.

Firstly, the taxpayers and the tax administrations need a lot of knowledge about the other country's tax system and its application *in casu* in order to identify the hybrid element and a mismatch attributable to it. In this regard, reference can be made to *John Peterson*, responsible for the hybrids project at the OECD, who recently wrote in International Tax Review[14]: "Work at the OECD will now turn to ensuring that tax administrations have the tools they need to implement these rules effectively. In particular, over the coming years, mechanisms will be put in place that ensure countries have access to the information they need to determine the tax treatment of instruments and entities in the counterparty jurisdiction…" – So far, so good. However, do countries which start implementation now, already have the tools and information they need? And what does it mean for business if they don't?

The second issue with the "automatic" application relates to the taxpayers' obligations when preparing their tax returns or self-assessments and to the final *burden of proof*. Will the application of a hybrids rule be assumed if, for example, a deductible payment is made to a group company because – in the absence of evidence to the contrary – the receiving group member *might* not be taxed as the result of a hybrid mismatch? Is a taxpayer obliged to investigate how a counterparty is taxed? Or is any payment deductible unless the tax administration presents facts which suggest or even prove the presence of a hybrid mismatch arrangement?

The Report is rather silent on these questions although, obviously, they are of utmost importance for business.

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12 Ibid, p. 3 (paragraph 5 of the foreword).
13 Ibid, m.no. 281.
14 http://www.internationaltaxreview.com/Article/3514500/Action-2-Neutralising-the-effect-of-hybrid-mismatch-arrangements.html, 15 December 2015.

In the following second part of this contribution the practical difficulties of such an approach will be illustrated by means of an example of existing law in Germany.

III. Some German experience

Germany had the privilege to be mentioned in the 2012 Hybrids Report as one of the few countries which had already introduced "Rules addressing the multiple deduction of the same expense" at that time.[15] That 2012 Report describes in paragraph 39 a provision in section 14 No. 5 of the Corporate Tax Act, the German Dual Consolidated Loss Rule. In 2012, when the Hybrids Report was written, this rule, although introduced with effect from 2001, had in fact never been applied by the tax administration.[16] From the beginning there was a serious lack of clarity about the rule's potential content. However, the tax administration had, for more than ten years, neither managed to issue an explanatory decree nor provided a box for an entry in the official tax return forms. Meanwhile, the rule has been tightened in 2013 and is indeed expected to be applied, although its unclear meaning is still not explained.

This rule is not too far from what the Final Hybrids Report suggests with regard to double deductions in hybrid entity scenarios. In Germany it is even claimed that there is no need for further action. However, there are reasons to respectfully disagree.

The German provision is too complicated and too far reaching. If a big country like Germany is not able, within more than ten years, to introduce a workable provision to combat the dual use of losses in cases which involve German group taxation ("Organschaft"), how can we expect that other countries will deliver acceptable domestic hybrid provisions in the future?

The rule, as modified in 2013, disallows the deduction of negative income incurred by either the parent or the subsidiary in an "Organschaft", insofar as "it" has been taken into account in a foreign country for the purpose of tax-

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15 OECD, Hybrid Mismatch Arrangements (n. 4), p. 15, m.no. 39. Reading this headline in this Report, one has the impression that this German rule refers to single expenses deducted more than once. But in fact this rule does not deal with single expenses, but expressly refers to "income", which is a balance of receipts less expenses.

16 DÖTSCH, Die Körperschaftsteuer, § 14 KStG m.no. 240 (at the end).

ing said parent or subsidiary or any other person. That is the complete rule; there are no further explanations or restrictions.

It is rather unusual for foreign countries to take into account any income as calculated for German tax purposes. However, the rule is silent on the question of how to deal with differences in income calculation, be they permanent or only timing differences.

If the rule is applied, the respective loss is eventually disregarded in Germany. There is no loss carry-forward; hence, economic double taxation over time is almost certain.

When is negative income taken into account by a foreign country when taxing one of the group companies or any other taxpayer? Is an actual effect on the tax payable required? Or is an increase of any taxpayer's loss carry-forward in any country sufficient?

Last but not least: Is the taxpayer required to give evidence that no foreign country recognizes his negative income for him or any other taxpayer? Would negative evidence of this kind be reasonable at all?

One may doubt whether the implementation of the Final Hybrids Report's recommendations will look much better in other countries. Why?

To a certain extent, the BEPS implementation is a political process and it is highly doubtful that politicians are interested in the tiny details of twelve hybrid recommendations. Again, German experience is not promising.

By the end of 2014, in view of and with express reference to the deliverable on hybrids of 16 September 2014[17], the German Federal Council ("Bundesrat") passed a bill with a new limitation for the double deduction of expenses. The draft expressly referred to hybrid mismatches and read: "Business expenses are only deductible insofar as the same expenses do not decrease the tax base in another country."[18] The provision would definitely have avoided any double deduction outcome if the German parliament ("Bundestag") had not rejected the bill. However, the draft wording is far from being perfect or even close to what the OECD has in mind. Again, there is no men-

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[17] OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

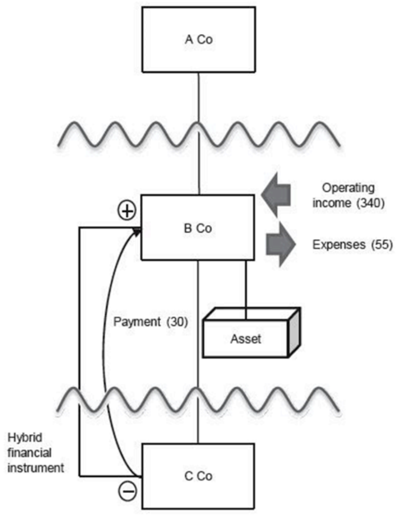
[18] "Die einer Betriebsausgabe zugrunde liegenden Aufwendungen sind nur abziehbar, soweit die nämlichen Aufwendungen nicht in einem anderen Staat die Steuerbemessungsgrundlage mindern." (BR-Drs. 432/14 (Beschluss), p. 12). Literally translated: "Expenses which underlie a business expense …".

tion of timing mismatches, a carry-forward, burden of proof and so on. And again, this was passed by one half of the German legislator, it was not the result of a political minority's initiative.

With that in mind, the following last part of this contribution will highlight some selected issues following from the examples part[19] of the Report.

IV. Selected issues from the examples part of the Final Hybrids Report

Example 1.24 of the Final Hybrids Report (p. 237)

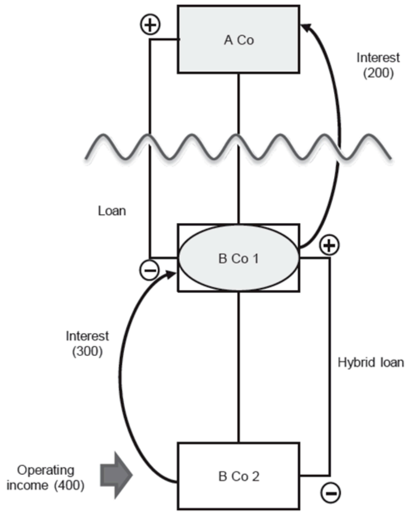


Firstly, example 1.24, which deals with hybrid instruments and CFC regimes, may be considered. In its first part, the Report clearly states that the operation of the recommended rules should not result in double taxation. Hence, CFC inclusion should be recognized. In example 1.24, A Co is subject to a CFC regime. The complexity of this example's analysis and the remarks on the evidence which the taxpayer, namely C Co, has to give to satisfy the tax administration about the taxation of B Co and about the mechanics of the CFC regime for A Co is remarkable. One may doubt whether

[19] OECD, BEPS Action 2 Report (n. 2), p. 169 et seqq.

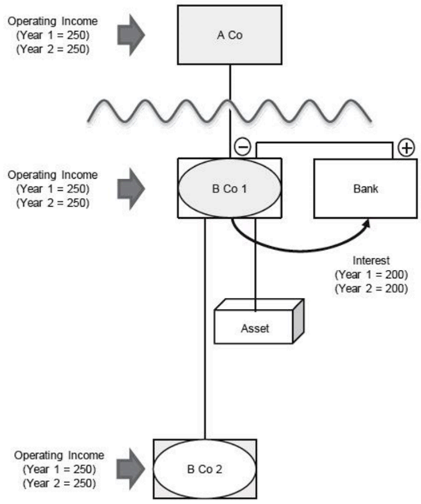
or not many countries are likely to draft their respective hybrid rules so as to take account of such CFC regimes in order to avoid double taxation.

Example 3.1 of the Final Hybrids Report (p. 288)



Example 3.1 is, in a nutshell, about a loan between A Co and B Co which is disregarded by country A. Consequently, country B in taxing B Co should apply the so-called disregarded payment rule as suggested in recommendation 3 and deny the deduction. Assume for a moment that such a rule is duly introduced in country B's tax law and remember what was said above about the German rules. In example 3.1, the facts of the case are clearly stated and undebatable. But how will the scenario look like in practice? Does the management of B Co have all knowledge about its shareholder A Co's tax position? Is the management required to make enquiries? Who has the burden of proof? Is it an appropriate suggestion to deny the deduction for B Co in the first instance and to include the payment into A Co's income only as a defence rule if country B does not introduce the primary response? Assume that B Co has minority shareholders; they would economically pay part of the bill.

Example 6.1 of the Final Hybrids Report (p. 310)

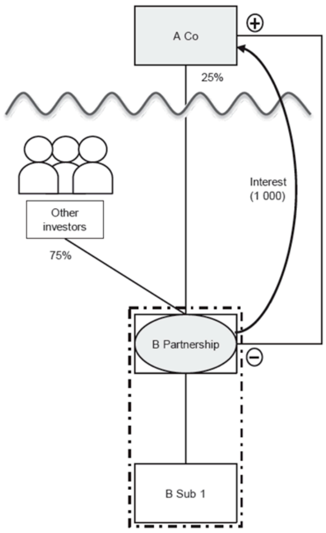


Example 6.1 gives a flavour of the challenges if a state wishes to properly take account of timing and valuation differences. The analysis of this generic – not real life – example with undebatable figures extends over six pages with quite a lot of extensive tables. Which tax inspector may have the necessary knowledge of foreign tax law and the facts and circumstances of a whole group of companies necessary to determine the correct amounts to be denied or included as the case may be?

There is an interesting detail in the OECD's analysis of this example. With regard to hybrid payments the Report states several times that the term "deductible payment" "would not typically cover the cost of acquiring a capital asset and would not extend to an allowance for a depreciation or amortization."[20] Nonetheless, the analysis of example 6.1 starts as follows: "B Co 1 is a hybrid payer …, the interest payments and depreciation allowances trigger a duplicate deduction for A Co (…). These payments will be treated as giving rise to a double deduction to the extent they exceed dual inclusion income."[21]

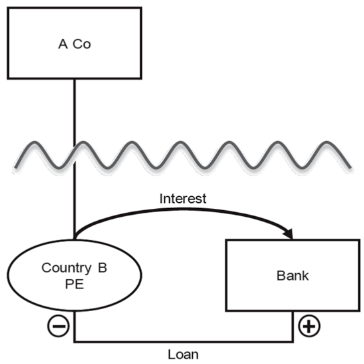
20 Ibid, m.no. 145. See also m.no. 121.
21 Ibid, example 6.1, p. 313, m.no. 13.

Example 6.5 of the Final Hybrids Report (p. 332)



In example 6.5 it is even suggested to prevent the partner of an alleged hybrid partnership "from claiming any net loss from the partnership."[22] If the Report gives countries a choice[23] as to what exactly the double deduction refers to, implementation is likely to be firstly arbitrary and secondly not coordinated.

Example 6.2 of the Final Hybrids Report (p. 317)



In the last example dealt with in this contribution, example 6.2, there is a PE of A Co in country B. Country A taxes the income from the PE as part of its

22 Ibid, example 6.5, p. 335, m.no. 12.
23 Ibid, p. 70, m.no. 192.

worldwide income. The situation does not necessarily look like the result of sophisticated aggressive tax planning. However, interest paid by the PE to a third party bank comes into the scope of the "Deductible hybrid payments rule" in recommendation 6. The Report requires country A to apply the primary response and to "deny the duplicate deduction for such payment to the extent it gives rise to a DD outcome"[24]; however, the interest may be carried forward and used in later periods.

According to the given facts the "PE has no other income."[25] (For a moment, it is assumed that the interest paid to the bank is nonetheless for purposes of the PE and thereby deductible in country B in general.) How can there be the danger of a double deduction? Anyway, the Report expressly bases its analysis on the fact that the loss in country B "may" be set-off in the future against non-dual inclusion income. The burden of proof is shifted to the taxpayer. Here, a quotation from paragraph 8 of the analysis requires consideration: "Unless the taxpayer can show that the interaction between Country A and B laws makes it practically impossible to utilise the deduction against anything other than dual inclusion income, the deduction should be treated as giving rise to a hybrid mismatch under Recommendation 6.3."[26] – With all due respect: this brings to mind the problematic "no possibilities" test in *Marks & Spencer*[27].

V. Résumé

As evidenced by its sheer length, the Final Hybrids Report contains probably one of the most problematic areas of the BEPS project. As the alleged shortfall of taxes cannot normally be attributed to a specific country, almost all attempts to counter the outcome of instruments or entities that are qualified differently by two states lack natural persuasiveness. In particular, the recommendations do not rely on the ability-to-pay principle. In view of the tremendous inherent difficulties of the subject it is not difficult to foresee a great variety of country-specific solutions, but no co-ordination.

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24 Ibid, recommendation 6.1(a). See already, as regards this issue before the release of the 2014 discussion draft on BEPS Action 2, in more detail LÜDICKE, "Tax Arbitrage" with Hybrid Entities: Challenges and Responses, p. 309, 310 et seqq.

25 Ibid, example 6.2, p. 317, m.no. 1.

26 Ibid, example 6.2, p. 318, m.no. 8.

27 CJEU, C-446/03, judgment of 13 December 2005, m.no. 55.

And the uncoordinated variety is likely to be increased by the Council of the EU's initiative of December 2015.[28] If they succeed in their proposed form, legislators of EU Member States will have to implement their requirements in addition to and irrespective of the OECD recommendations. Astonishingly, there are fundamental differences. Whereas the OECD route is not to touch upon the qualification of hybrid entities by countries as such, the EU proposal requires either one or the other Member State, as the case may be, to treat an otherwise transparent entity opaque or *vice versa*.[29] – National legislators in the EU might be forced to develop a sort of "matrix legislation".[30]

National parliaments should carefully consider any implementation steps. Intense discussions with business and academia might help to avoid disastrous provisions like those we have seen in Germany. Legislators should seriously strive to avoid unattainable burden of proof for taxpayers and unintended double taxation.

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28 See. note from the Presidency to the Working Party on Tax Questions – Direct Taxation, doc. no. 14544/15, of 2 December 2015. After the Symposium of international tax law in Lausanne on 19 and 20 January 2016 the EU Commission published a revised proposal for an anti-BEPS directive on 28 January 2016, see Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM(2016) 26 final, 2016/0011 (CNS), of 28 January 2016.

29 COM(2016) 26 final (n. 28), Article 10 Hybrid Mismatches.

30 It is noteworthy that after the Symposium of international tax law in Lausanne on 19 and 20 January 2016 the content of the proposal has been amended several times and is still under discussion. In the last published version of the proposal (of 15 April 2016) the hybrid mismatch rules do not contain this corresponding qualification; the rules have rather come closer to the proposals of the OECD but still leave several questions open.

IV. Selected bibliography

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