

The Chamber of Tax Consultants

Hybrid Mismatch Arrangements – BEPS Action 2 Report and Transparent Entities and Elimination of Double Taxation - Articles 3 and 5 of MLI

5th October 2019

**Naresh Ajwani
Chartered Accountant
Rashmin Sanghvi and Associates**

Background

Hybrid

- **Hybrid** – having a mix of two or more characteristics or attributes. In context of BEPS, it applies to Hybrid entity and Hybrid financial instrument.
- Differences in treatment of entities or financial instruments by the countries gives rise to Hybrid entities or Hybrid financial instruments.
- This can give rise to **Tax Regulatory Arbitrage**.

Hybrid

- **Hybrid entity** – treated as taxable entity (opaque) in one country and pass through entity (transparent) in another country.
- **Hybrid instrument** – payment treated as deductible payment (e.g. interest) in one country and exempt receipt (e.g. dividend) in another country.
- This difference (mismatch) can result in double non-taxation or double taxation.

BEPS Action 2 report

- Action 2 report deals with Hybrid mismatch arrangements.
- It is one of the most exhaustive reports. Helps to understand global tax planning.
- It is Work in process. Countries are introducing anti-hybrid mismatch rules. One will have to wait for the outcomes.

- In this presentation, a glimpse of the report is given.

BEPS Action 2 report

- The report suggests provisions in domestic law.
- Action 2 report has resulted in MLI Article 3 on Transparent Entities, and Article 5 on Application of Methods for Elimination of Double Taxation.
- Other articles in the MLI also help in dealing with Hybrids.

BEPS Action 2 report

- The report targets “mismatch”.
Mismatch” is a situation which results in:
 - Deduction of payment in payer’s country but is not included as ordinary income in the payee’s country (**Deduction / No Inclusion or D/NI outcome**).
 - Deduction of expenses in two - countries (**Double Deduction or DD outcome**).
 - includes an expected mismatch.

BEPS Action 2 report

- Timing differences or valuation differences are not considered for DD or D/Ni outcomes.
- The report targets **double non-taxation** and not double taxation.

BEPS Action 2 suggestions

- Action 2 suggestions and the MLI articles 3 and 5 are **not minimum standards**. Hence countries may decide not to follow it.
- Articles 3 and 5 of MLI are specific anti-avoidance rules tackling specific issues just as other MLI articles.

Some terms used in Hybrid arrangements

Transparent entity

- Transparent entity means that the entity is not taxed. Instead its members / partners are taxed as if the entity did not exist.
- India has partial transparency. Firm and partner both can be taxed.
- In US and Europe, partners are taxed.

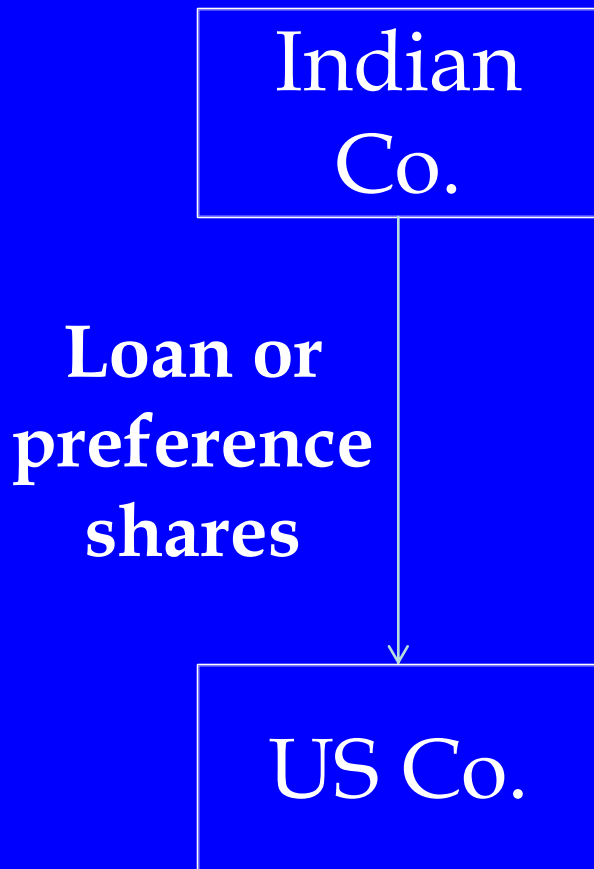
Indian DTAs

- The normal language - "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein.....(Article on residence)
- If a foreign firm is not liable to tax in its country, is DTA benefit available?

Indian DTAs

- Some DTAs state - in the case of income derived or paid by a partnership, etc....this term applies only to the extent the income is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. [e.g. USA and UK DTAs]

Hybrid Instrument



- Indian company gives a loan to its US subsidiary.
- Interest taxed @ 15% in USA; and 30% in India.
- Net tax cost – 30%.
- However...Next slide...

Hybrid Instrument

- Instead of loan, Indian company invests in Preference shares redeemable at premium.
- In USA, premium on redeemable preference shares is treated as interest. US will levy tax @ 15% on interest.
- In India – inflation adjusted capital gain on redemption of preference shares may be almost NIL.
- Tax cost – 15%.

Hybrid Mismatch Arrangement (HMA)

- HMA exploits differences in tax treatments of the entity or the instruments in two countries to achieve double non-taxation or tax deferral.
- Anti-HMA rules do not apply to capital assets or depreciation or goods. These however can apply to payments like royalty, rents, payment for services.

HMA...can result in...

- Deduction in one country without corresponding income in the other.
- Multiple deduction for single expense.
- Multiple foreign tax credits for one foreign tax amount.

Structured arrangement

- Structured arrangement is –
 - any arrangement where the hybrid mismatch is priced into the terms of the arrangement or,
 - the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.
- Arrangement means any agreement, understanding.... Broad meaning...

Structured arrangement

- Some examples:
 - arrangement that is marketed as a tax-advantaged product (which is derived from the hybrid mismatch).
 - arrangement that alter the terms under the arrangement, if the hybrid mismatch is removed.
 - arrangement that would produce a negative return without hybrid mismatch.

Action report 2 – some recommendations

Domestic law recommendations

- Report recommends Anti-HMA rules which should be incorporated in domestic law.
- Countries are free to not apply rules for HMA. The other country can apply the rules to prevent HMA.

Domestic law recommendations

- Domestic law recommendations target:
 - payments deductible in payer country but not included as income of the payee (**D/NI**).
 - payments resulting in two deductions in respect of the same payment (**DD**).
 - payments deductible in payer country but receipt is set-off by the payee against a deduction under a hybrid mismatch arrangement (**Indirect D/NI**).

D/NI outcomes targetted

Hybrid mismatch resulting from following transactions:

- Payment under financial instrument.
- Disregarded payment by hybrid payer.
- Payment made to reverse hybrid.

DD outcomes targetted

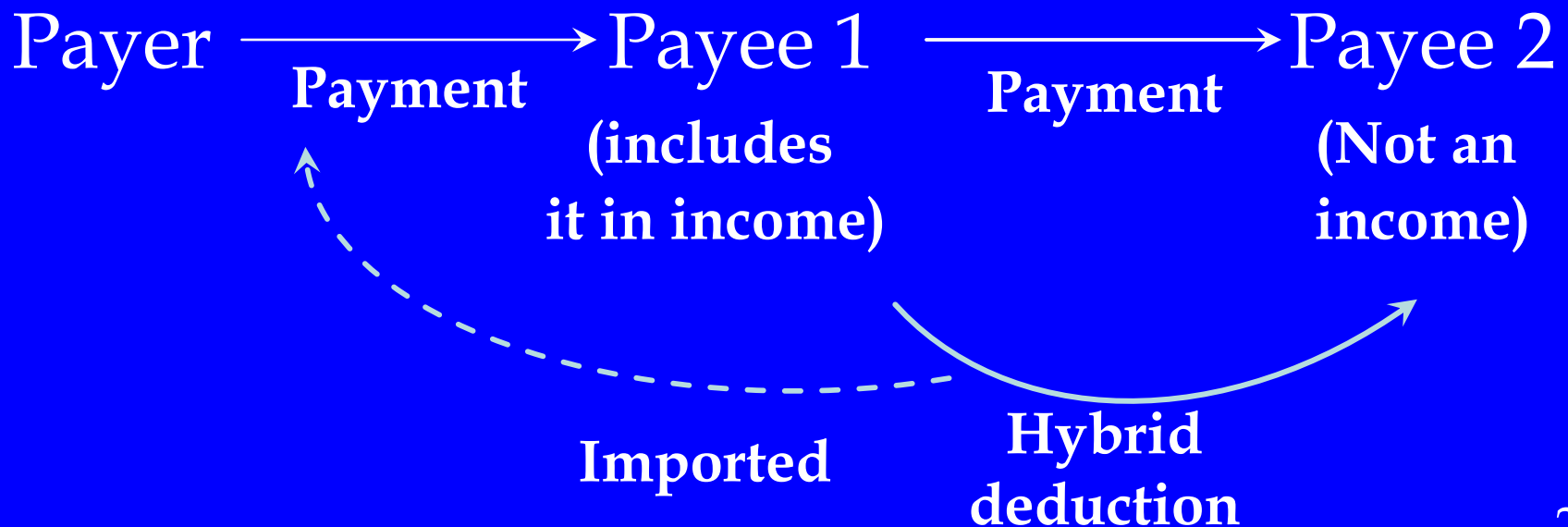
Double deductions resulting from following transactions:

- Payment by hybrid payer.
- Payment by dual resident.

Indirect D/NI outcomes targetted

Deductions resulting from Imported mismatch as under:

- Payment to a payee who sets of the receipt against hybrid deduction in its country.



Hybrid Financial Instrument

- Anti-HMA rule will apply to a payment under “financial instrument” if it results in Hybrid “mismatch” (D/NI).
- Financial instrument means arrangement that is taxed under rules for taxing debt, equity or derivatives.
- Hybrid mismatch should be due to terms of the financial instrument. If it is due to status of the tax payer, it is not Hybrid mismatch.

Hybrid Financial Instrument

- Financial instrument also includes “hybrid transfer” – i.e. where financial instrument is transferred and both parties treat it as their investment. They consider return from the investment as exempted in their countries.
- Rule also applies to “substitute payment” – payment made for transfer of financial instrument to the extent of financing / equity return if it results D/NI outcome.

Hybrid Financial Instrument

- The rule will apply to payment to a “related person”; or if it is a “structured arrangement” where taxpayer is a party to structured arrangement.

Hybrid Financial Instrument

- Primary rule – country of payer should deny the deduction of expense.
- Defensive rule – If payer country does not deny the deduction, payee's country should add the amount as income.

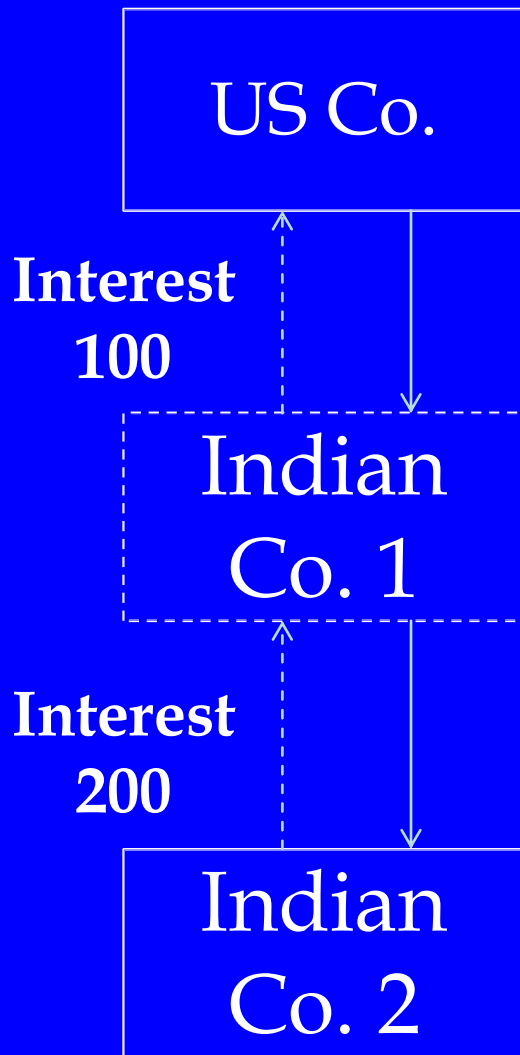
Disregarded payment

- “Disregarded payment” by Hybrid payer means payment deducted in payer country, but disregarded in payee’s country (D/NI).
- Primary rule – country of payer should deny the deduction of expense.
- Defensive rule – If payer country does not deny the deduction, payee’s country should add the amount as income.

Disregarded payment

- It is **not restricted** to financial instrument. It can apply even in case of payment for royalty, services... current business expenditure.
- The rule applies to mismatch under same group, or under structured arrangement.

Disregarded payment

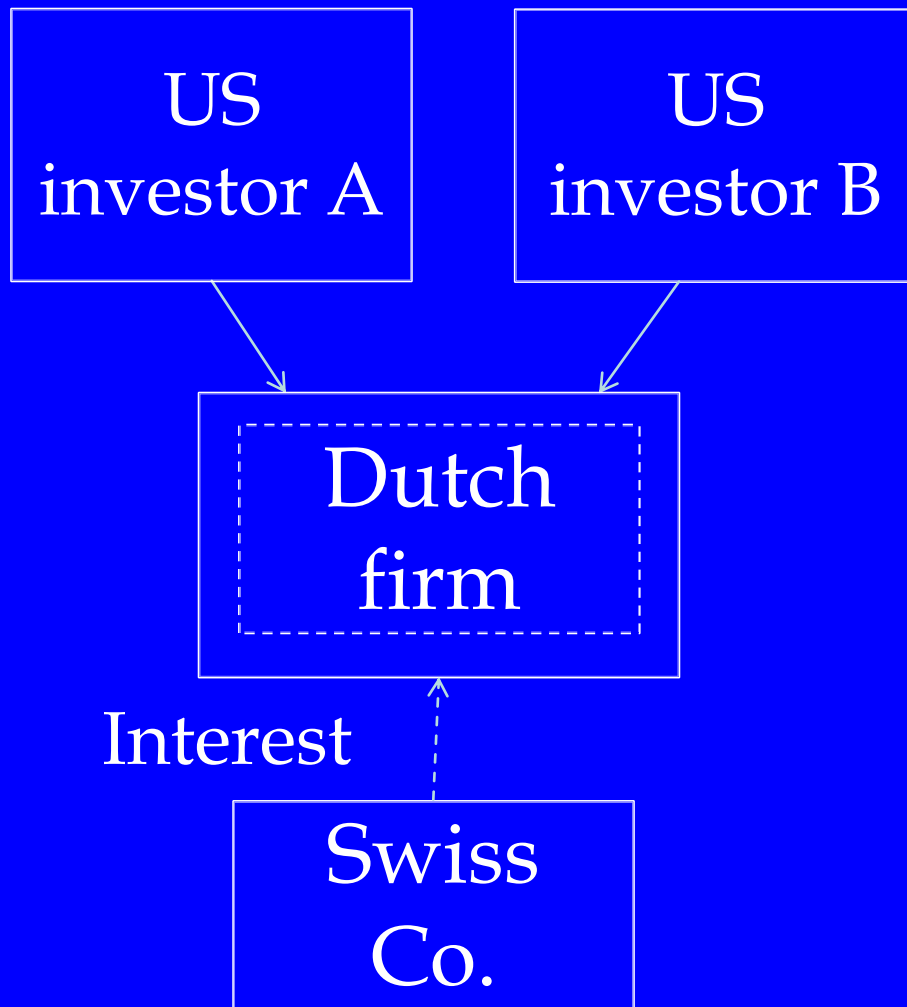


- India considers ICO1 as separate co. It grants deduction for interest.
- US Co. does not tax interest as it disregards ICO1 and the interest received.
- US Co. considers 100 as exempt dividend.
- Leads to Hybrid mismatch.

Reverse Hybrid

- Payment to Reverse Hybrid that results in Hybrid mismatch (D/NI).
- Reverse Hybrid means - Investor treats entity as opaque but Establishment country considers it as transparent.
- Primary rule - country of payer should deny the deduction of expense.
- Defensive rule - NIL.
- The rule applies to mismatch under same group, or under structured arrangement.

Reverse Hybrid



- US investors consider Dutch firm as opaque. They do not offer interest to tax in USA.
- Netherlands considers Dutch firm as transparent. It does not tax the firm.

D/NI Outcome - DTA

- Can denying the deduction under domestic law be permitted under a DTA?
- Once profits are attributed as per DTA, whether the expenses are deductible or not, depends on domestic law. (Para 30 of commentary on Article 7 of OECD MC).
- Non-discrimination clause also does not restrict such a deduction. Anti-HMA rules is based on treatment of payment in hands of payers and payees.

Payment by Hybrid Payer

- Payment by Hybrid payer that results in deduction in payer and payee countries **(DD)**.
- Primary rule – country of parent should deny the deduction of expense.
- Defensive rule – Payer country should deny deduction.

Payment by Hybrid Payer

- For parent, there is no need of same group or structured arrangement requirement.
- For payee, rule applies to mismatch under same group, or under structured arrangement.

Payment by Dual Resident

- Payment by a dual resident person that results in double deduction (**DD**).
- Primary rule – country of residence should deny the deduction of expense. (Double disallowance.)
- Defensive rule – NIL.
- No requirement of same group, or a structured arrangement.

Imported mismatch payment

- Indirect D/NI can result due to “Imported mismatch” payment.
- Imported mismatch means HMA with a payee in whose country hybrid mismatch rules don't apply. Payee enters into any of mismatch resulting in D/NI or DD outcomes. Thus mismatch in payee country is imported in payer country.

Imported mismatch payment

- Primary rule – Payer country should deny deduction.
- Defensive rule – NIL.
- The rule applies to mismatch under same group, or under structured arrangement.

DTA recommendations

Objectives:

- Hybrid instruments and entities, and dual resident entities do not unduly take advantages of DTA.
- Action 6 report (Preventing Treaty Abuse) suggestions should take care of several HMA. These are dealt with through various MLI articles. Next slide...

HMA – Action 6 suggestions

- Limitation of Benefits rules.
- Principal Purpose Test.
- Minimum shareholding period for lower rate of tax on dividend.
- Country's rights to tax its own residents.
- PE in third states – anti-abuse rule.

Dual Resident Entities

- Dual resident entities will be provided DTA relief on case by case basis.
- If countries cannot find a solution, DTA relief will not be given.

[This is amongst the harshest provisions.]

[This article is dealt with by another speaker.]

Anti-HMA rules – double tax

- If anti-HMA rules results in double tax, there is no specific solution.
- Action 2 report suggests that countries should co-ordinate.
- Report advises that tax payer should arrange transactions to avoid double tax. (See example 7.1 in the Report.) [To that extent, it should not be considered as tax planning.]

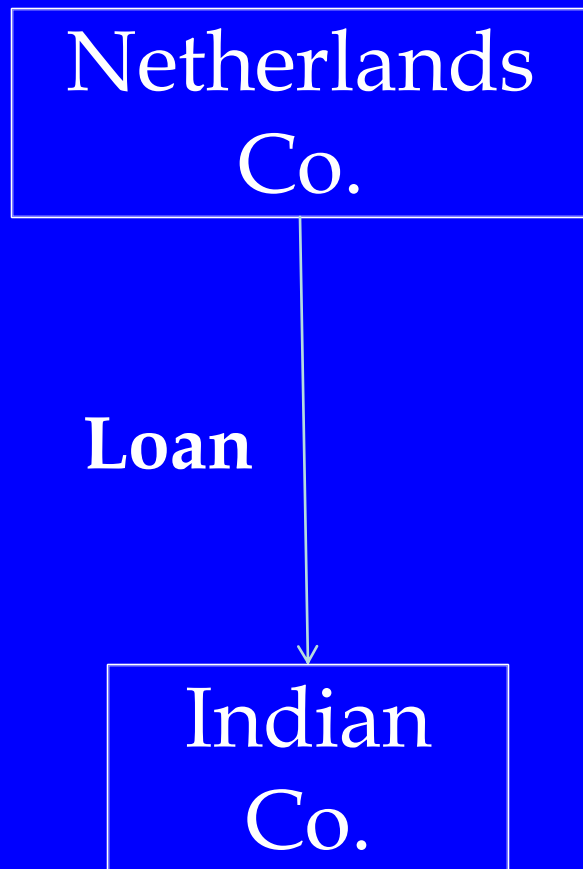
Transparent entity

- Hybrid entities (transparent entities) should get appropriate benefit but only to the extent income is considered as earned by a resident.
- At the same time, if income is not taxed as that of a resident, DTA relief will not be allowed.

Other provisions

- Credit method can be considered instead of Exemption method – for dividend only, or for all incomes.

India position



- Interest paid by ICO is deductible expense.
- NCO considers it as dividend and does not tax.
- This gives rise to D/NL.
- In absence of anti-HMA rule, can India disallow interest deduction? No.

India position

- Can GAAR rules apply to HMA? (Some countries are incorporating Anti-HMA rules. E.g. Australia, Netherlands. Australia is doing it under GAAR rules.)
- Anti-HMA rules will be relevant to foreign companies owned by Indian parent in countries with Anti-HMA rules.

Multilateral Instrument

MLI - Article 3 - Transparent Entities

- Clause 1 - In case of transparent entities (where entity is not taxed but members are taxed), COS will apply the DTA relief only to that much income which is taxable in the hands of member of COR.

MLI - Article 3

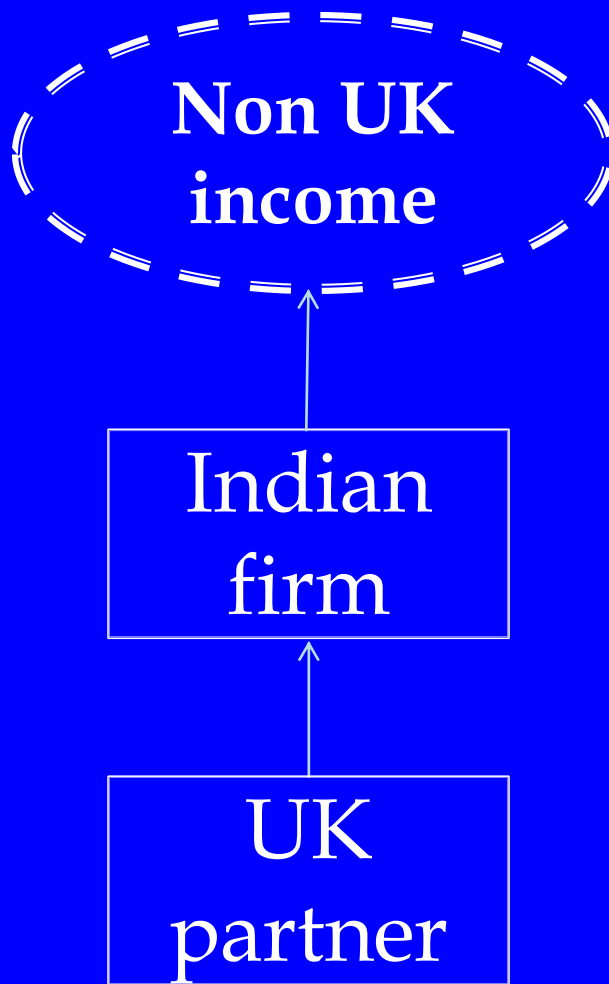
- Clause 3 - Article 11 of MLI provides that country's right to tax its residents will not be affected. However country can make reservation for article 11 not to apply. If a country makes such a reservation, the right to tax its residents will remain under article 3(1).

MLI - Article 3

- Clause 2 - COR which exempts income or provides foreign tax credit for income taxed in COS, DOES NOT have to give such relief - if COS taxes the income solely because income is also considered as that of resident of COS. This is as per BEPS Action 6 report.

Example in next slide...

MLI - Article 3

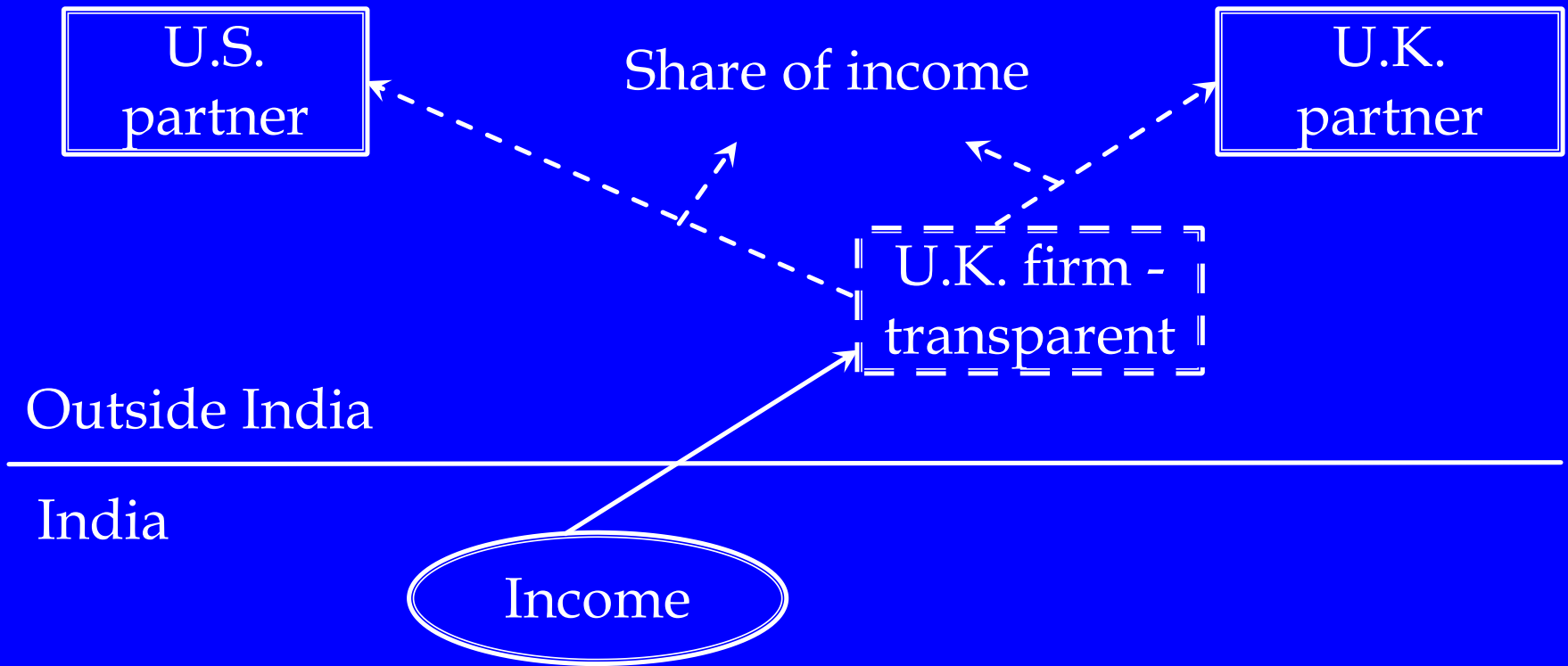


- India will tax the firm as resident.
- UK will tax the partner as it treats firm as transparent.
- Normally India is required to give credit for UK tax.
- However as UK taxes the income solely because partner is a resident (not due to UK source), India does not have to give FTC.

India position

- India has made a reservation. This article will not apply. India's view is that DTA cannot apply to entities of 3rd country. OECD view is that this can apply to entities of 3rd country.

India position



India will not apply India-US DTA to income derived by US partner from U.K. firm.

It will apply India-U.K. DTA to income derived by U.K. partner.

India position

- Difficulty of foreign firms not being permitted DTA relief continues.
- Controversy for Indian partner getting foreign tax credit in a foreign firm continues.
- This article is relevant to foreign subsidiaries / Joint Venture companies of Indian parent company.

MLI – Article 5 – Elimination of Double Tax

- Article 5 of MLI provides 3 options:
 - A) If COR normally exempts **income** arising in COS, it will NOT EXEMPT such income which is also exempted by COS or COS taxes at a lower rate. If COS taxes at a lower rate, COR will provide credit for the same.

MLI - Article 5

B) If COR normally exempts dividend income arising in COS, it will NOT EXEMPT such income if COS gives a deduction for such dividend. If COR taxes dividend, COR will provide credit for the same.

C) Credit method of tax has to be followed to eliminate double tax.

MLI - Article 5

- If one country does not choose option C, it can choose that the other country also should not apply Option C. (E.g. Switzerland)
- Except for Option C where one country can restrict the other country from applying Option C, this article can apply differently in each country.
- This is asymmetric application of MLI provision.

India position

- India has opted for Option C. Most of the DTAs are already on these lines. India follows this method. Hence MLI will have very little implication.
- Option C will apply to Egypt and Slovak DTA. Slovak already has such a provision. Hence no implication.
- India-Greece DTA has exemption method. Greece has reserved the application of this article to Indian DTA. Hence MLI article does not apply.

Questions and comments welcome

Naresh Ajwani
naresh@rashminsanghvi.com