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OECD report on cross-border hybrid mismatch arrangements, UN publishes model double taxation convention

The first two weeks of March have seen the publication of several important multilateral documents that are relevant to US Inbound tax. These multilateral events are the publication of a report on cross-border hybrid mismatch arrangements by the OECD and the publication of the 2011 update to the UN Model Double Taxation Convention Between Developed and Developing Countries.

OECD report on cross-border hybrid mismatch arrangements

On March 5, 2012, the Organisation for Economic Co-operation and Development (the "OECD") issued a report entitled *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (the "OECD Report" or the "Report"). The OECD Report identifies tax policy issues that arise as a result of hybrid mismatch arrangements and identifies certain options that may be implemented by member governments to address these perceived mismatches. This report was prepared by Working Party No. 10 on Exchange of Information and Tax Compliance of the Committee on Fiscal Affairs with the assistance of its Aggressive Tax Planning Steering Group. The Report does not address tax treaty implications of hybrid mismatch arrangements, which are being addressed by Working Party No. 1 on Tax Conventions and Related Questions.

Observations: The issuance of the OECD Report is another recent example of a multi-jurisdictional approach to combat differences in the tax treatment of hybrid

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instruments, entities or transfers between two or more countries. In addition to the focus on such arrangements by the OECD, the European Union and the United States also are focused on such arrangements.

For example, on February 29, 2012, the European Commission announced a public consultation document requesting comments on the issue of "double non-taxation" in the context of corporate income taxes within the European Union (the "EU") and in relation to third countries (*i.e.,* countries not members of the EU, such as the United States). In this context, "double non-taxation" generally is understood to mean situations where cross-border activities are either not taxed at all or are taxed at an extremely low rate. Issues identified by the European Commission in the consultation paper include mismatches of entities (*i.e.,* cases where an entity is regarded for tax purposes as opaque in one country and transparent in another) and mismatches of financial instruments (*i.e.,* cases where a financial instrument is treated as equity under the law of one EU member state and debt under the laws of another member state).

In the United States, the Internal Revenue Service (the "IRS") has increased its examination focus during the past several years on intercompany debt arrangements, including cross-border hybrid transactions. Until recently, such transactions were designated as a Tier 1 (High Strategic Importance) audit issue and required the involvement of a technical advisor. (Note that the IRS announced its intent in October 2011 to move from a tiering system for coordinated issues, and instead is focusing on domestic and international tax issues through "Issue Practice Groups." The International Business Compliance (IBC) Inbound or "IBC Inbound" Group focuses on inbound financing issues including intercompany loans and interest expense, and repatriation/ withholding issues.)

Background to the OECD report

The OECD Report generally defines the concept of hybrid mismatch arrangements as arrangements that exploit differences in tax treatment of instruments, entities or transfers between two or more countries. Such arrangements may lead to double non-taxation or tax deferral, which if maintained over a several year period, may be economically similar to double non-taxation. The Report explains that although comprehensive data on the collective tax revenue loss resulting from the implementation of hybrid mismatch arrangements is not available, amounts at stake in various jurisdictions are described as "substantial." For example, court cases in New Zealand settled in 2009 for EUR 1.3 billion, court cases settled in Italy for EUR 1.5 billion and USD 3.5 billion reportedly is at stake in the United States with respect to foreign tax credit generator transactions.

The OECD has previously considered tax issues presented by hybrid mismatch arrangements. In 2010 and 2011, the OECD issued two reports on certain issues raised by hybrid mismatch arrangements -- *Addressing Tax Risks Involving Bank Losses* and *Corporate Loss Utilisation through Aggressive Tax Planning*, respectively. In *Addressing Tax Risks Involving Bank Losses*, the OECD highlighted the issue of hybrid mismatch arrangements in the context of international banking and recommended that, in order to determine whether steps should be taken to eliminate what were perceived as arbitrage/mismatch opportunities, revenue authorities bring to the attention of government tax policy officials those situations where the same tax loss is relieved in more than one country as a result of differing tax treatment. Similarly, countries were advised to consider restricting the multiple use of the same loss in *Corporate Loss Utilisation Through Aggressive Tax Planning*.

Common elements and common effects of hybrid mismatch arrangements

The Report identifies four common elements of hybrid mismatch arrangements:

- *Hybrid entities*: entities that are treated as transparent for tax purposes in one country and as non-transparent or opaque in another country;
- *Dual residence entities:* entities resident in two different countries for tax purposes;
- *Hybrid instruments*: instruments treated differently for tax purposes in more than one country (*e.g.,* as debt in one country and equity in another country); and
- *Hybrid transfers*: arrangements treated as transfers of ownership of an asset for tax purposes in one country but not for tax purposes of another country, which may view the arrangement as a collateralized loan.

The Report identifies three common effects of hybrid mismatch arrangements:

- *Double deduction schemes:* arrangements where a deduction is claimed for income tax purposes in two different countries;
- *Deduction/no inclusion schemes:* arrangements that create a deduction in one country (*e.g.,* a deduction for interest expense) but do not result in a corresponding income inclusion in another country; and
- *Foreign tax credit generators:* arrangements that generate foreign tax credits that arguably would not otherwise be available, or not to the same extent, or not without more corresponding foreign taxable income.

The OECD is of the view that hybrid mismatch arrangements raise serious policy issues, including lost tax revenue, unintended competitive advantages for large enterprises as compared with small or medium-sized enterprises that cannot easily benefit from mismatch opportunities, economic inefficiencies impacting capital export neutrality and capital import neutrality, lack of transparency with regard to the general public that is unaware of mismatch opportunities, and fairness (*i.e.,* mismatch opportunities are available to taxpayers with income from capital rather than labor).

Policy options addressing hybrid mismatch arrangements

The OECD Report explains that, in principle, there are a number of domestic law options to address hybrid mismatch arrangements. They include harmonization of domestic laws, the implementation of general anti-avoidance rules, specific anti-avoidance rules and rules specifically focusing on hybrid mismatch arrangements. Certain policy options appear to be dismissed in the Report, such as the harmonization of domestic law, which is described as an option that does not seem "possible", and the implementation of general anti-avoidance rules which, although they are an effective tool, are described as not always providing a comprehensive response to double non-taxation cases.

The Report focuses in detail on rules introduced in a number of OECD member countries which specifically address hybrid mismatch arrangements. Under such rules generally, the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in the foreign country, resulting in the elimination of the possibility of mismatches. Domestic rules that address hybrid mismatch arrangements include rules that (1) target multiple deductions of the same expense (discussion includes rules implemented in Denmark, Germany, New Zealand, the United Kingdom and the United States), (2) address the deduction of payments not included in the recipient's taxable income (such rules have been implemented in Denmark and the United Kingdom), (3) focus on the non-inclusion of income that is deductible for the payor (such rules have been implemented in Austria, Denmark, Germany, Italy, New Zealand and the United Kingdom), and (4) address abusive foreign tax credit transactions (such rules have been implemented in Italy, the United Kingdom and the United States).

United Nations' model double taxation convention between developed and developing countries

On March 15, 2012 at the meeting of the Committee of Experts on International Cooperation in Tax Matters (the "UN Committee"), a subgroup of the Economic and Social Council, the United Nations formally launched the 2011 Updated Model Double Taxation Convention Between Developed and Developing Countries (the "2011 Update"). The main objective of the revisions to the UN Model Convention as reflected in the 2011 Update was to take into account developments in international tax policies relevant for developing and developed countries. Key revisions of the 2011 Update, which is a 483 page document (including country-specific commentaries on the articles of the 2011 Update), are in relation to binding arbitration, exchange of information, assistance in the collection of taxes, taxation of capital gains and permanent establishments. The 2011 Update is a culmination of a 10-year effort to revise the last update made to the UN Model Convention in 1999.

The general approach of the 2011 Update is to preserve a greater share of tax revenue to the "source State" (that is, the country where investment or other activity occurs), whereas the general approach of the OECD Model Convention is to preserve a greater share of tax revenue to the "residence State" (that is, the country of the investor or trader). Although the UN Model Convention often is heavily relied upon by developing countries in bilateral treaty negotiations, and is anticipated to be more widely used following the publication of the 2011 Update, it should be noted that at least one key UN member has stated that the 2011 Update does not take into account the concerns of developing countries. In a March 12, 2012 letter to the Director, Financing for Development Office, the Indian Joint Secretary (FT & TR-I) and Competent Authority, Sanjay Kumar Mishra, noted that the 2011 Update was developed by a Group of Experts and sub-committee members who disproportionately represent OECD member countries, which does not include developing countries as its members. The Indian Joint Secretary and Competent Authority also stated in his letter that "the recommendations of the Committee of Experts (1999) that the OECD principles as set out in the OECD Transfer Pricing Guidelines should be followed, must be ignored."

The UN efforts and other international efforts to assist developing countries in tax administration and the formulation of tax policy can be seen as a positive development for the international business community. A structured and principle-based approach to tax administration can reduce uncertainty of tax results and lead to more uniformity and acceptance of internationally accepted norms.

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