Some thoughts on Action Item 2 - Hybrids

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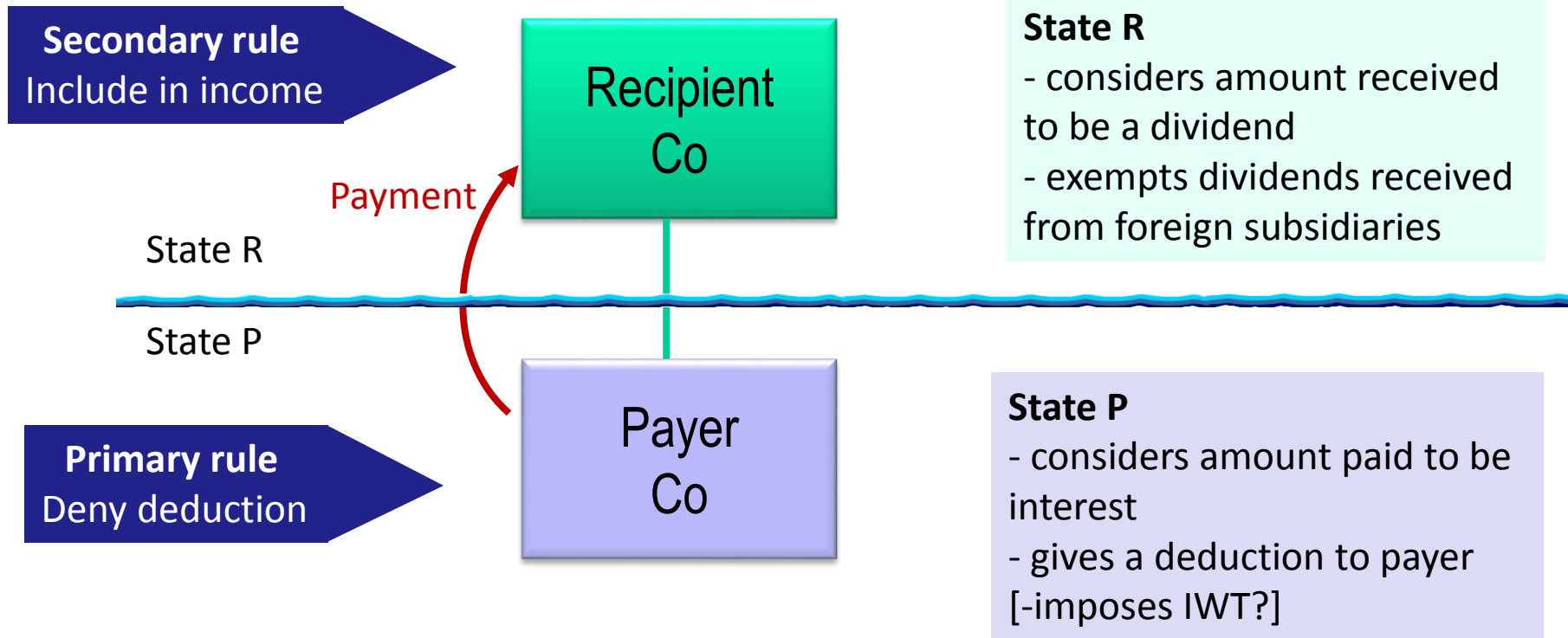
IFA – Japan branch

18 February, 2015
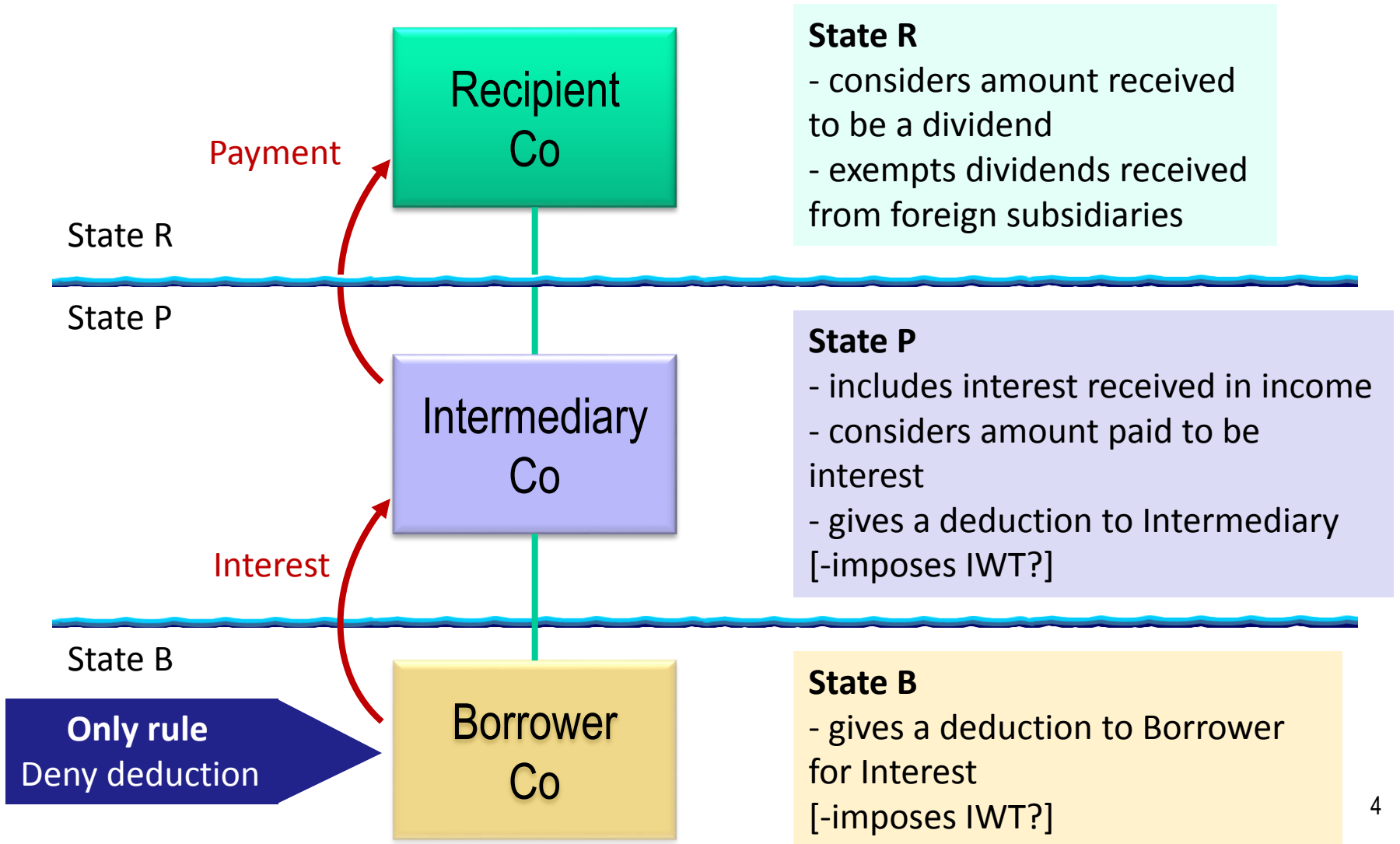
The underlying problem

▶ Disagreements can be everywhere

▶ With us, tax idiosyncrasy is the norm (Australian exceptionalism)

▶ The 7 Examples reflect disagreements about
- debt v. equity
  - ▶ hybrid financial instruments
  - ▶ imported hybrids
- Transactions – sale v. secured borrowing
  - ▶ hybrid transfers
- existence / number of entities
  - ▶ receipts by owner from 'hybrid payer'
  - ▶ receipts by 'reverse hybrid'
  - ▶ payment by 'hybrid payer'
  - ▶ 'dual consolidated' entities

Hybrid financial instrument

Secondary rule
Include in income

Primary rule
Deny deduction

Recipient Co

Payer Co

State R

State P

Payment

State R
- considers amount received to be a dividend
- exempts dividends received from foreign subsidiaries

State P
- considers amount paid to be interest
- gives a deduction to payer
[-imposes IWT?]

'Imported mismatch'

State R
- considers amount received to be a dividend
- exempts dividends received from foreign subsidiaries

State P
- includes interest received in income
- considers amount paid to be interest
- gives a deduction to Intermediary [-imposes IWT?]

State B
- gives a deduction to Borrower for Interest
[-imposes IWT?]

State R

State P

State B

Recipient Co

Intermediary Co

Borrower Co

Payment

Interest

Only rule Deny deduction

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'Hybrid transfer'

Borrower Co

Primary rule
Deny deduction
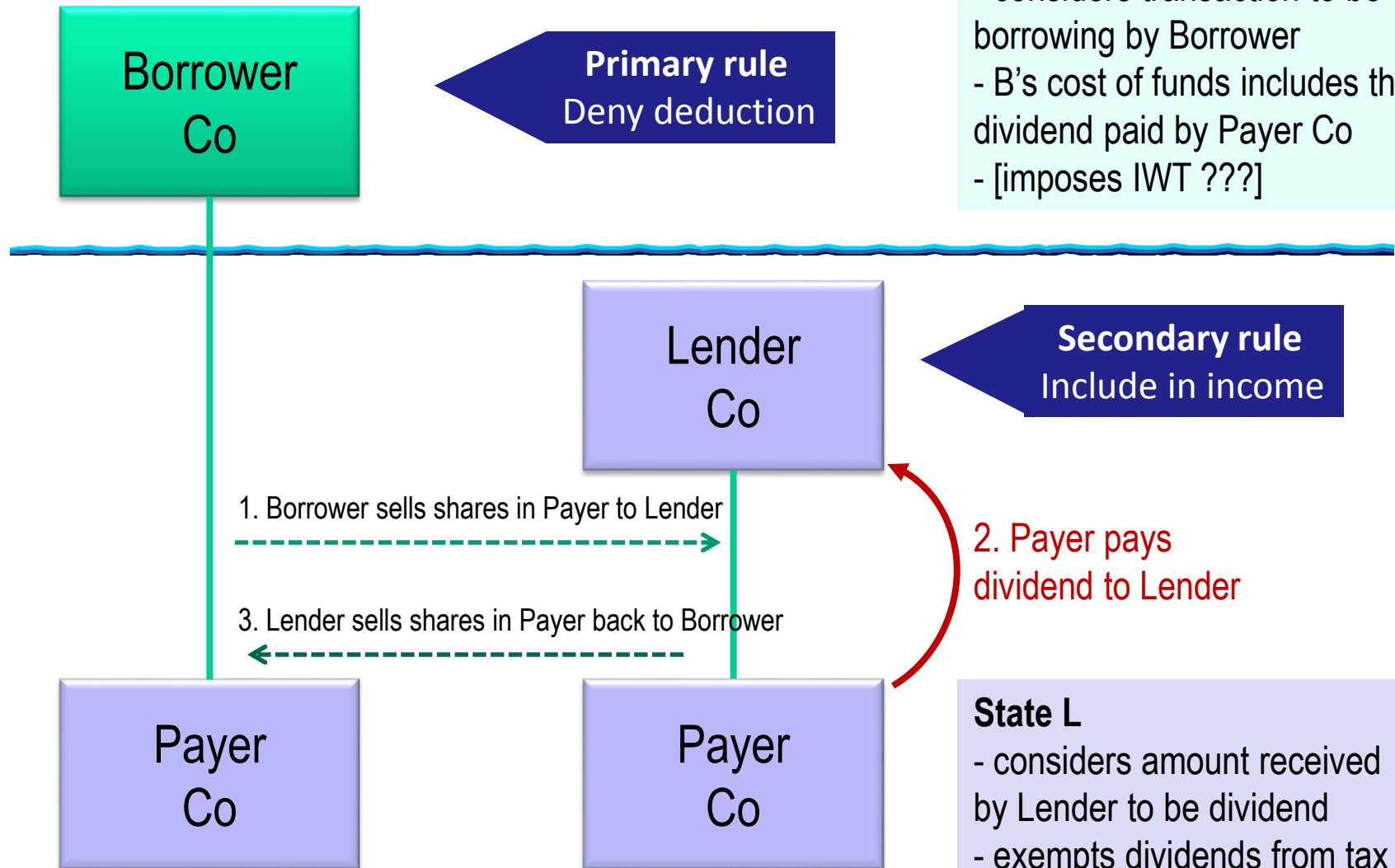
State B
- considers transaction to be borrowing by Borrower
- B's cost of funds includes the dividend paid by Payer Co
- [imposes IWT ???]

Lender Co

Secondary rule
Include in income

1. Borrower sells shares in Payer to Lender

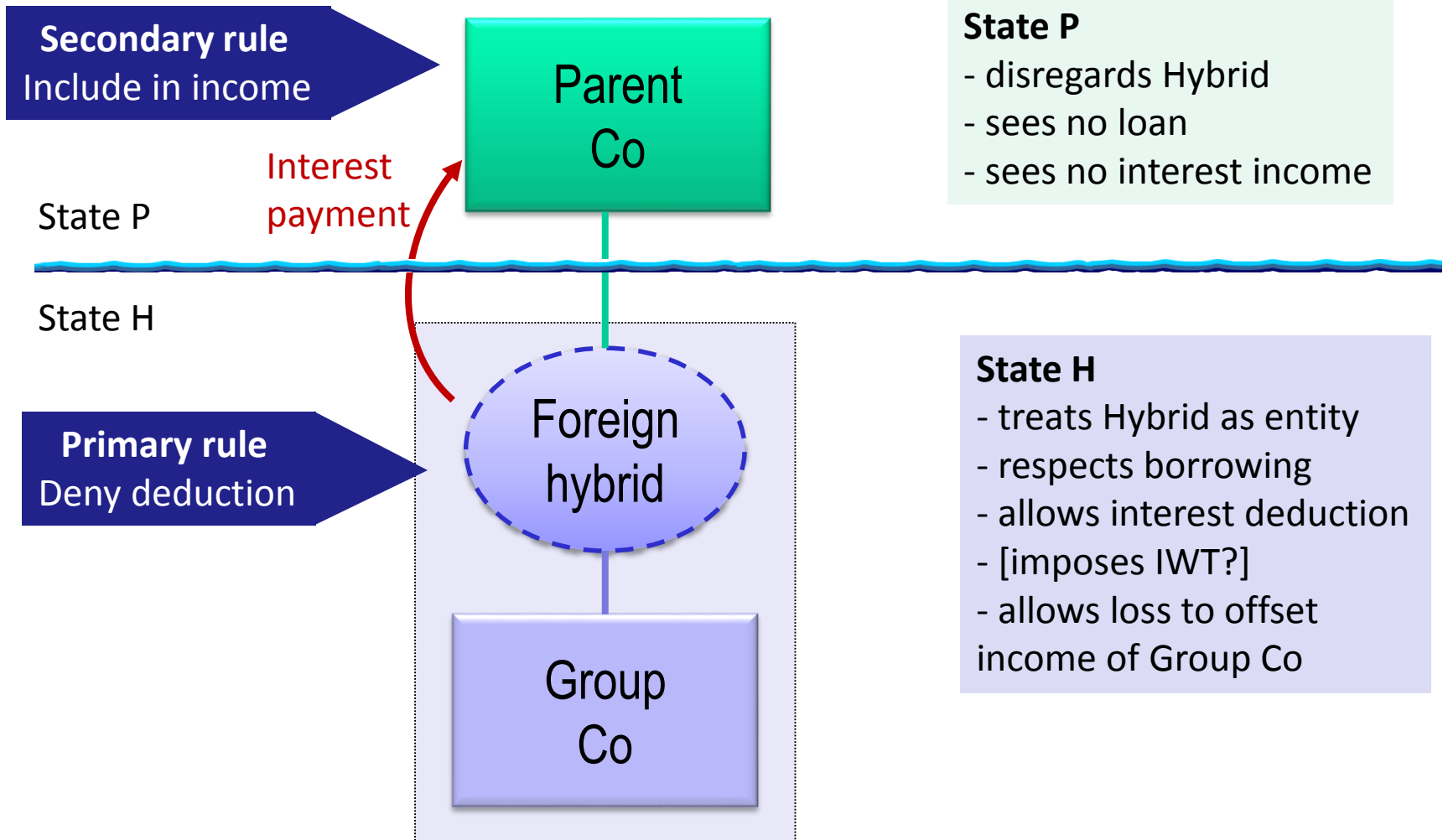2. Payer pays dividend to Lender
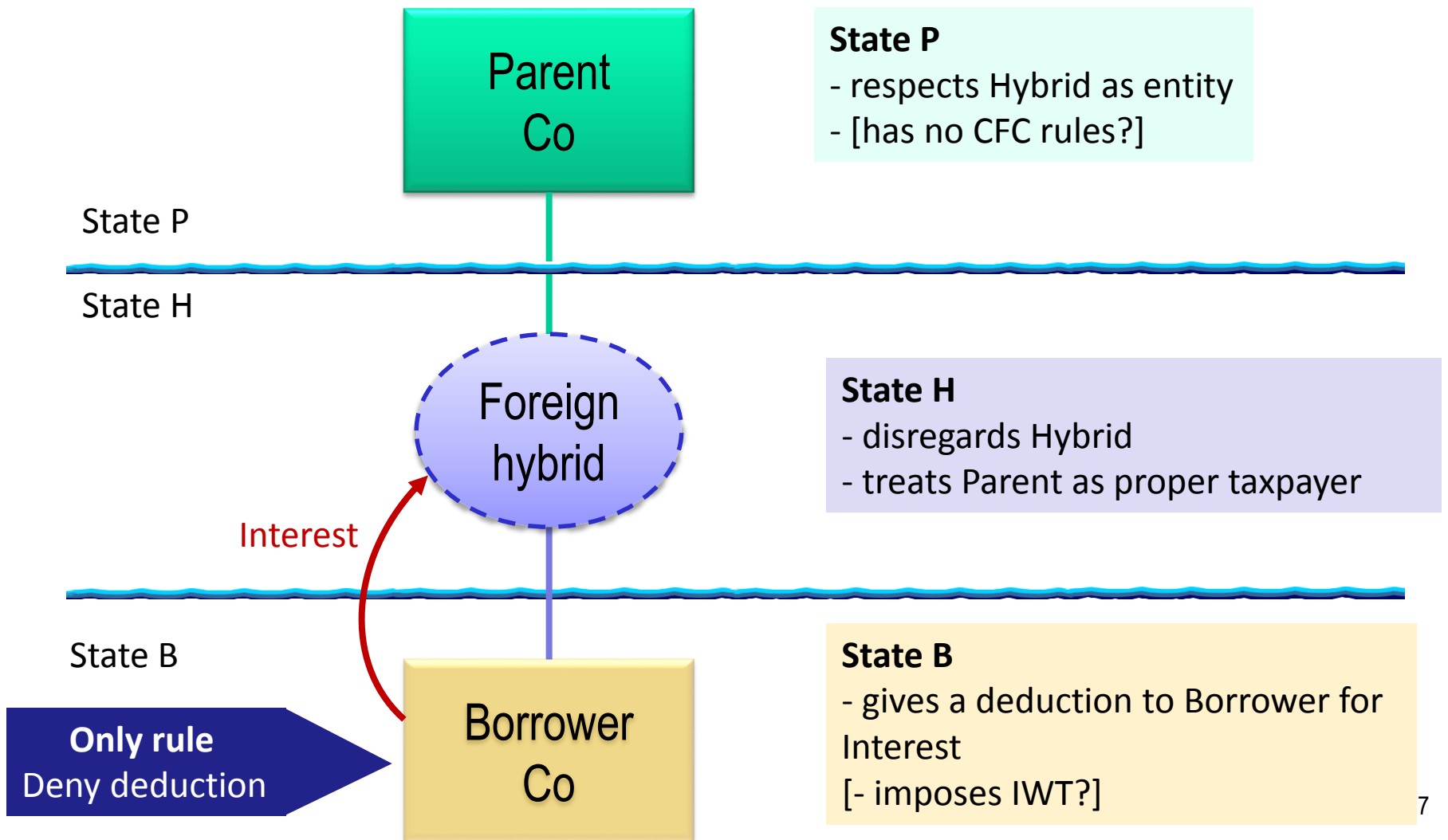
3. Lender sells shares in Payer back to Borrower

Payer Co

Payer Co

State L
- considers amount received by Lender to be dividend
- exempts dividends from tax

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Payment made **by** hybrid entity (to Parent)

Secondary rule
Include in income

Parent
Co

Interest
payment

State P

State H

Primary rule
Deny deduction

Foreign
hybrid

Group
Co

State P
- disregards Hybrid
- sees no loan
- sees no interest income

State H
- treats Hybrid as entity
- respects borrowing
- allows interest deduction
- [imposes IWT?]
- allows loss to offset
income of Group Co

Payment **to** reverse hybrid

Parent Co

State P
- respects Hybrid as entity
- [has no CFC rules?]

State P

State H

Foreign hybrid

State H
- disregards Hybrid
- treats Parent as proper taxpayer

Interest

State B

Borrower Co

State B
- gives a deduction to Borrower for Interest
[- imposes IWT?]

Only rule
Deny deduction

Payment made **by** hybrid entity (to third party)

State P
- disregards Hybrid
- sees borrowing by Parent Co
- allows Parent interest deduction
- [imposes IWT?]

Primary rule
Deny deduction

Parent Co

State P

State H

Secondary rule
Deny deduction

Foreign hybrid

Interest payment

Bank

Group Co

State H
- treats Hybrid as entity
- respects borrowing
- allows interest deduction to H
- allows loss to offset
income of Group Co
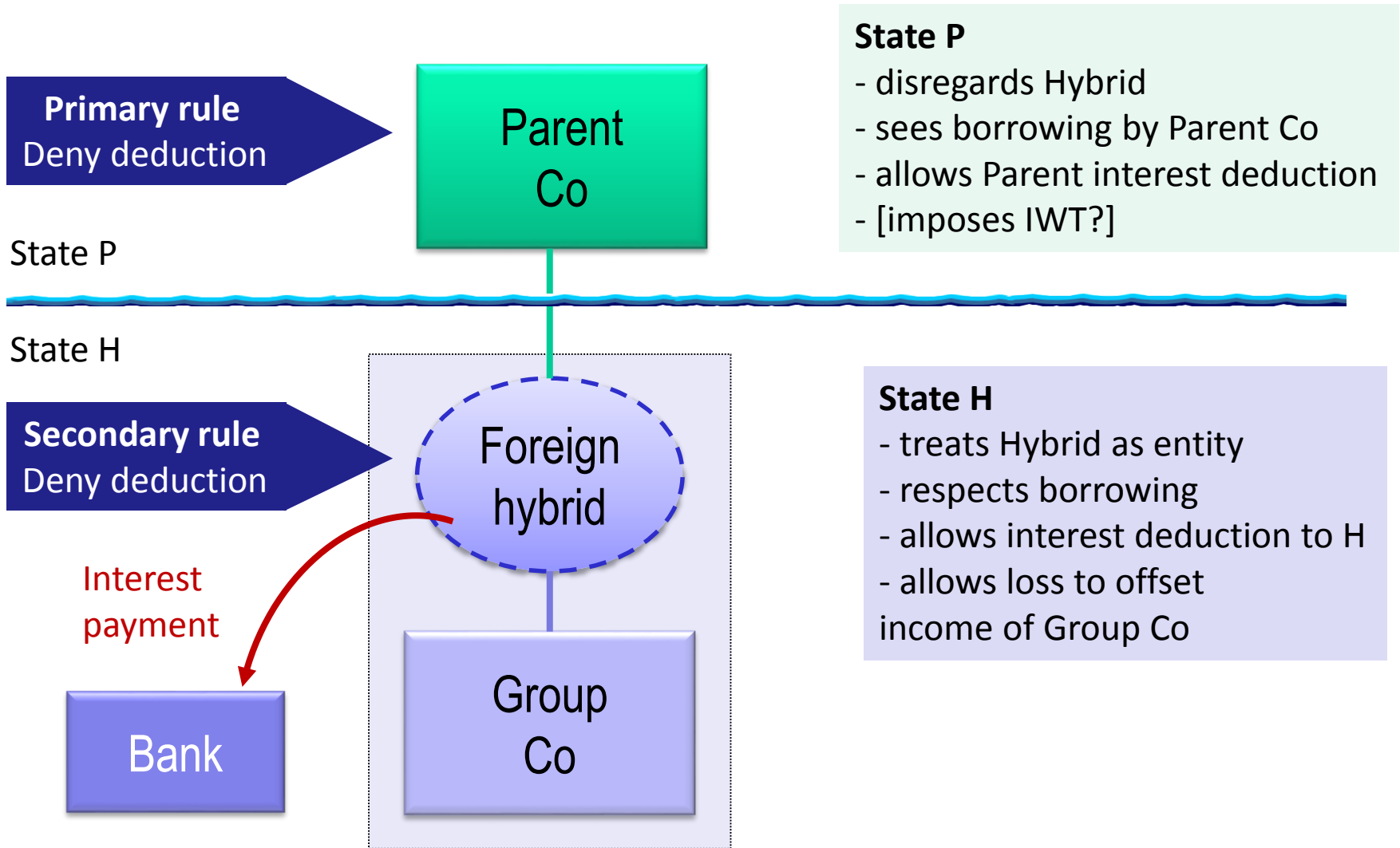
Payment made **by** dual resident entity (to third party)

State P
- allows interest deduction to P-Sub A group
- [imposes IWT?]

Only rule
Each state deny deduction

State S
- allows interest deduction to Sub A-Sub B group

State P
State S

Parent Co

Sub A

Sub B

Bank

Interest payment
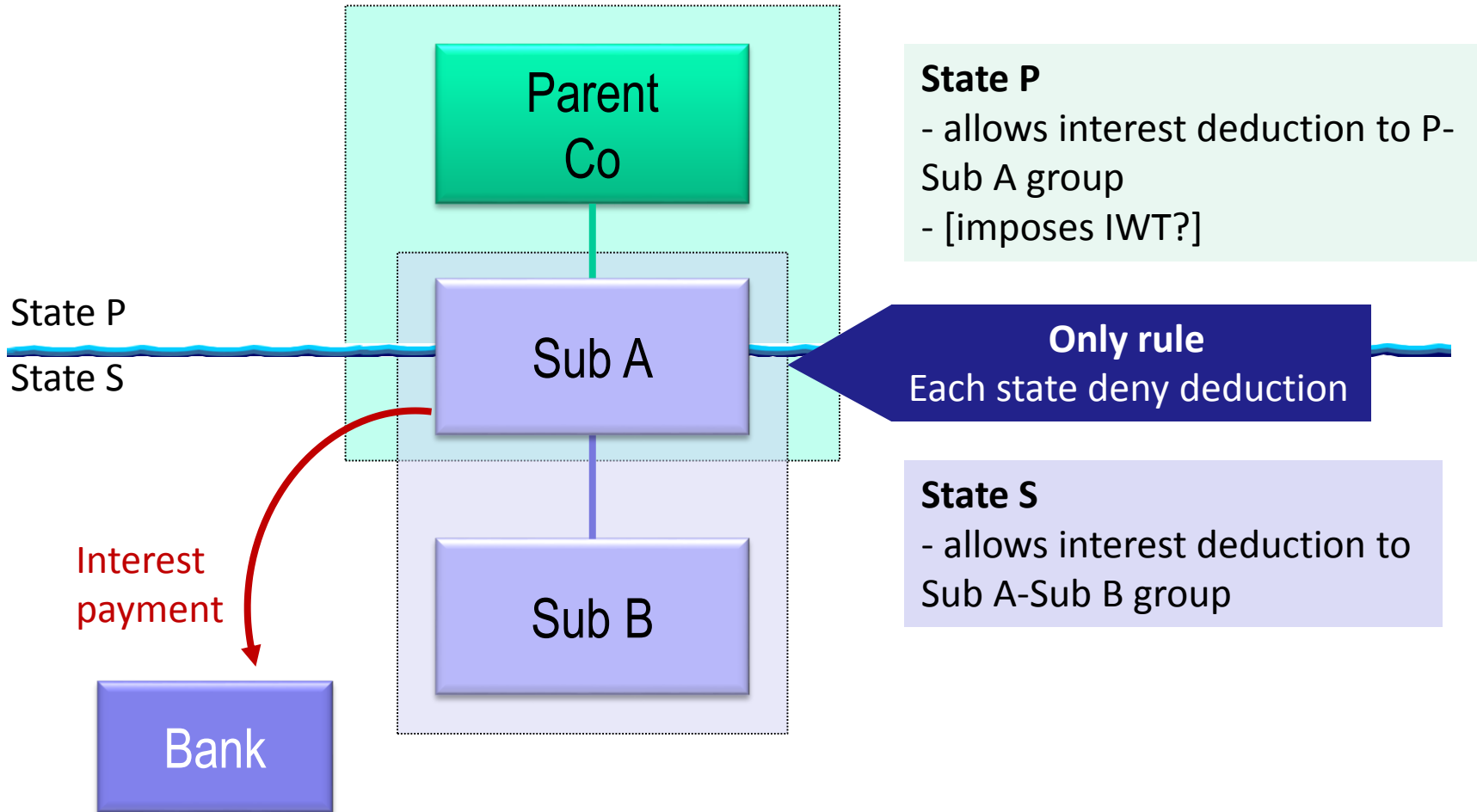
- Both State P and State S allow consolidation of resident companies only
- Sub A is incorporated in State P; managed in State S

A small target

▶ Hybrid outcome
- affecting instrument that is debt / equity / derivative

▶ Between related or controlled entities; part of a structured arrangement
- presumably a marker for avoidance

▶ involving physical payments
- between the parties to the arrangement?

▶ but not timing

▶ which generates an overall (not individual) revenue loss
- compared to …?

▶ resulting a D / NI outcome or a DD outcome
- but not NI / NI
- nor FTC / FTC

Comments

▶ The remedy is deliberately
- domestic
  ▶ improve domestic law
  ▶ an anti-hybrid rule that gets turned on
  ▶ and adjusts to get turned off
- unharmonised
- agnostic

▶ So the BEPS policy gets shifted closer to, 'all income must be taxed somewhere'
- and either country is sufficient

▶ Becoming dependent upon actions of other countries

- ▶ Treating companies as real and final
- ▶ Solving every problem by denying deductions
  - what about CFCs / IWT / entity recognition rules
- ▶ What happened to withholding taxes
- ▶ Consistent with the BEPS paradigm
  - or rules that will be BEPS engines?