Canadian companies who have international structures that involve the use of either a hybrid instrument or a hybrid entity will want to closely follow the recent high-profile initiatives by the Organisation for Economic Co-operation and Development (OECD) in this area. Specifically, you will want to consider the impact of potential future tax changes that Canada may introduce to curtail the use of these types of arrangements as a result of the OECD’s progress on its hybrid mismatch arrangements consultations. The OECD launched its consultation process with the release of two detailed consultation papers on March 19, 2014 as part of its ambitious Action Plan on Base Erosion and Profit Shifting (BEPS). The OECD’s consultation period on hybrid mismatch arrangements ends on May 3, 2014.

Many types of corporations will want to follow these OECD consultations. For example, Canadian companies who have arrangements that include a hybrid instrument, such as preferred share investments in a Luxembourg financing company or a U.S. corporate group, or a hybrid entity such as a US “tower” financing structure. Likewise, foreign-based companies with operations in Canada will want to consider the effect of potential tax changes on their financing arrangements into Canada.

**OECD Action Plan — Background**

The OECD Action Plan, which was presented at the meeting of G20 Finance Ministers on July 19, 2013, makes 15 recommendations that focus on key areas including the digital economy, hybrid mismatch arrangements, controlled foreign corporation (CFC) rules, excessive intercompany interest payments, harmful tax practices, treaty abuse, avoidance of permanent establishment status, transfer pricing, aggressive tax planning, and greater transparency and disclosure. (See TaxNewsFlash-Canada 2013-27, "OECD Action Plan Could Signal a Shift in the Global Tax Landscape").

The OECD’s recommendations may lead to new rules that could have a significant effect on multinational corporations that undertake generally accepted tax planning, including transfer pricing and intra-group financing transactions. In addition, the OECD proposes that countries should largely complete the action on tax base erosion and profit shifting in a two-year period, which may present a significant challenge for countries.

In its 2014 federal budget, the Canadian government announced a parallel consultation process on BEPS and has set a consultation period for interested parties to provide input to the Department of Finance by June 11, 2014. Previously, Finance released a statement
The OECD’s consultations to curb the use of hybrid mismatch arrangements are laid out in a two-part discussion paper. The first part provides recommendations for domestic law changes and includes a detailed discussion on the types of arrangements that could fall within the scope of such changes (the Domestic Law Discussion Draft). The second part of the OECD discussion paper addresses issues that could arise under income tax treaties as a result of the recommendations in the Domestic Law Discussion Draft, and includes a proposal for a new treaty measure dealing with transparent entities (the Treaty Discussion Draft).

What is a hybrid mismatch arrangement?

The Domestic Law Discussion Draft describes a hybrid mismatch arrangement as a profit shifting technique that exploits a difference in the characterization of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes for payments made under the arrangement. As a result, a payment would be characterized differently in the payer’s jurisdiction than in the recipient’s jurisdiction.

The paper discusses two key mismatch arrangements:

- Arrangements that produce a deduction under the rules in the payer’s jurisdiction and no income inclusion in the recipient’s jurisdiction
- Arrangements that produce a deduction in both the payer’s and the recipient’s jurisdiction.

According to the OECD, these results can be achieved through the use of a hybrid instrument (where there is a difference in the treatment of the same instrument under the laws of two or more jurisdictions), or through the use of a hybrid entity (where the same entity is treated differently under the laws of two or more jurisdictions).

KPMG observations

The Domestic Law Discussion Draft focuses on arrangements that exploit differences in the way a payment is characterized in the jurisdiction of payment and the jurisdiction of receipt to achieve profit shifting and base erosion outcomes. However, the paper also points out that there are other types of arrangements that do not specifically involve a “payment” but that also effectively lower the aggregate tax burden of the parties involved. For example, notional deductions for invested equity or debt would not involve “payments” per se, but would result in aggregate tax reductions. Although this consultation paper does not specifically target these types of arrangements, they could fall within the scope of other OECD initiatives under the BEPS Action Plan.

Examples of hybrid mismatch arrangements
There are a number of outbound financing arrangements available to Canadian companies that involve the use of hybrid instruments or hybrid entities. Three examples are outlined below.

**Hybrid instruments — Luxembourg finance companies**
Canadian companies could hold mandatory redeemable preferred shares (MRPS) in a Luxembourg financing company. The MRPS are viewed as a share investment in a foreign affiliate under Canada's tax rules, and distributions made by the financing company would be treated as dividends paid from the surplus accounts of that affiliate. From a Luxembourg tax perspective, the MRPS are viewed as debt and the distributions are treated as deductible interest payments. As a result, the MRPS are considered a hybrid instrument that produces a deduction in Luxembourg but no equivalent income inclusion in Canada to the extent that the dividend is considered to be paid from the affiliate's exempt surplus.

**Hybrid instruments — Repurchase transactions (REPO)**
Canadian companies could hold a preferred share investment in a U.S. group. The preferred shares, which are subject to a repurchase agreement, are viewed as giving rise to a debt instrument for U.S. tax purposes, with the payments being treated as a deductible interest expense. For Canadian tax purposes, the preferred shares are viewed as an equity investment, with the payments thereon being treated as dividends paid from the surplus accounts of a foreign affiliate. As a result, the preferred shares are considered a hybrid instrument that produces a deduction in the U.S. but no equivalent income inclusion in Canada to the extent that the dividend is considered to be paid from the affiliate's exempt surplus.

**Hybrid entities – U.S. tower structures**
Canadian companies could use “tower” structures for financing U.S. acquisitions. These structures involve a partnership with Canadian partners which “checks the box” to be treated as a corporation for U.S. tax purposes. In this case, the partnership borrows from external lenders and the funds are ultimately on-loaned to another U.S. group member for purposes of making the acquisition. Because the borrowing entity is treated as a partnership for Canadian tax purposes, the interest on the external loan is allocated to the Canadian partners as a deductible expense. For U.S. tax purposes, the interest expense in the check-the-box entity offsets the interest income on the on-loaned funds on a consolidated basis and no net taxable income arises. As a result of the different treatment of the partnership under Canadian and U.S. tax law, the structure provides a double deduction for the interest expense (in the U.S. and in Canada), and only one income inclusion for the related interest income (in the U.S.).

These financing arrangements would all fall under the ambit of the OECD’s definition of a "hybrid mismatch arrangement" as they result in either a deduction with no equivalent income inclusion or a double deduction. These arrangements could be subject to the OECD's proposed recommendations, as outlined below.

**OECD design for domestic hybrid mismatch rules**
The Domestic Law Discussion Draft lays out a number of parameters for the design of domestic law hybrid mismatch rules. According to the OECD, each country should ensure that these rules:

- Eliminate the mismatch without requiring the relevant jurisdiction to establish that it has “lost” tax revenue
- Are comprehensive, clear and transparent
- Apply automatically
- Avoid double taxation through co-ordination of the relevant law
- Minimize the disruption to existing domestic law
- Allow co-ordination with the counterparty jurisdiction while providing flexibility to incorporate the rules into the laws of both jurisdictions
- Are workable for taxpayers while keeping compliance costs to a minimum
- Are easy for tax authorities to administer.

**KPMG observations**

While these design parameters seem fairly straightforward on paper, it may be difficult to implement rules that adhere to all of these ideals. According to the OECD paper, the rules are intended to drive taxpayers towards less complicated and more transparent structuring. To achieve this goal, however, each jurisdiction would need to follow the same general plan for the design of their rules. Therefore, multi-jurisdictional coordination could be one of the key considerations for the successful development of domestic law changes. The scope of changes, if any, that countries are willing to make in this regard could vary widely and therefore could create income tax tensions if some level of coordination is not attained.

**OECD recommendations for domestic law changes**

The OECD’s specific recommendations differ depending on whether the mismatch arises as a result of a hybrid instrument or a hybrid entity.

**Hybrid instrument proposals**

For hybrid instruments, the Domestic Law Discussion Draft recommends that:

- Jurisdictions should deny a deduction for any payment made under a hybrid financial instrument where the recipient does not include the payment in its ordinary income
- Jurisdictions should require the recipient to include a payment made under a hybrid financial instrument in ordinary income where the payer is entitled to claim a deduction for the payment and the payer’s jurisdiction does not apply a hybrid mismatch rule (as described above)
- Jurisdictions should not grant a dividend exemption under domestic law to the extent it is a deductible payment to the payer (although not specifically stated, this appears to be an alternative to the previous recommendation).

**Hybrid entity proposals**
For hybrid entities the Domestic Law Discussion Draft recommends that:

- Jurisdictions should deny the deduction that arises in the parent’s jurisdiction where it exceeds the amount, if any, of income that is included in both the parent’s and the subsidiary’s jurisdiction.
- In the event that the rule above does not apply, jurisdictions should deny the deduction in the subsidiary’s jurisdiction to the extent it exceeds the amount, if any, of income included in both the parent’s and the subsidiary’s jurisdiction.

These recommendations essentially remove the “double dip” nature of hybrid arrangements by denying deductions where no equivalent income is recognized or by including an amount in income where a deduction is claimed.

**Canada’s hybrid mismatch legislative history**

**Double dip legislation**

While not specifically targeting hybrid mismatch arrangements, in 2007 the Canadian government attempted to implement legislation to restrict the deductibility of certain financing expenses for double-dip structures that sought to obtain two interest deductions in two different jurisdictions for two different taxpayers. Those proposals were significant criticized by the tax and business communities and were subsequently repealed based on recommendations by the Advisory Panel on Canada’s System of International Taxation. The Panel concluded that, at the time, the proposals would have a negative effect on Canadian multinationals' foreign investment in the existing global economy.

**Hybrid entities — Canada-U.S. tax treaty**

The 2007 protocol to the Canada-U.S. treaty was essentially the first piece of tax law to deal with Canadian hybrid mismatch arrangements. The treaty provisions focus on hybrid entities and accomplish two goals. The provisions:

- Allow a taxpayer to claim treaty benefits where income of a hybrid entity is subject to tax in the taxpayer's jurisdiction of residence
- Prevent a taxpayer from claiming treaty benefits where income of a hybrid entity is treated differently based on the entity’s characterization in the jurisdiction of the recipient’s residence (the anti-hybrid rules).

**KPMG observations**

Although Canada’s tax laws do not allow entities to be treated as something that they are not as a matter of law, U.S. tax laws do. This allows hybrid entities to be used in Canada-U.S. cross-border planning, as seen in the tower structure example outlined above. The Canada-U.S. treaty is Canada’s only treaty that contains hybrid entity rules, which is not surprising given the vast amount of cross-border transactions between the two countries.

**Hybrid instruments — Foreign tax credit generator rules**

In 2010, Finance introduced measures targeted at the creation of foreign tax credits and
deductions where the government believed the foreign tax was not economically paid. Although not specifically dependent on the existence of a hybrid instrument, the rules apply where the taxpayer is considered to own less shares in a foreign affiliate under foreign tax law than under Canadian tax law. In the Luxembourg financing structure outlined above, the Canadian company would be treated as owning 100% of the MRPS under Canadian tax law whereas, under Luxembourg tax law, the Canadian company would be considered to own no MRPS, since the MRPS are considered to be debt and not equity. As a result, the foreign tax credit generator rules could potentially apply.

KPMG observations
Although certain hybrid instruments could be subject to the foreign tax credit generator measures, the result of their application is limited. In general, the rules deny a deduction for foreign tax against any foreign accrual property income (FAPI) that is included in the Canadian company’s income.

As illustrated above, Canada does have some targeted rules that apply to certain hybrid arrangements, but it does not currently have a comprehensive set of hybrid mismatch provisions such as those recommended by the OECD.

OECD recommendations for treaty changes
The Treaty Discussion Draft analyzes the interaction between the recommendations included in the Domestic Law Discussion Draft and tax treaties, and requests comments on this relationship. In considering how the residence article in the OECD Model Tax Convention applies to transparent entities, the OECD’s only recommendation is to add a new paragraph to the Model Treaty to allow treaty benefits where income is derived by or through an entity or arrangement that is treated as fiscally transparent under the tax law of either jurisdiction. This rule would only apply where the income is subject to tax in the hands of a resident of one of the contracting jurisdictions.

KPMG observations
As discussed above, the Canada-U.S. treaty contains very similar provisions to the OECD’s proposed change to its model treaty for hybrid entities. Because Canadians are familiar with such measures in the context of U.S. cross-border planning, this proposed change should have little effect on current Canadian-U.S. structures.

Next steps
The creation and enactment of new domestic tax law takes time in every country. The recommended changes in the OECD’s Domestic Law Discussion Draft represent a significant tax policy shift in most countries, and it could be challenging to draft such extensive new laws to appropriately target the arrangements that are of concern. It remains to be seen whether Canada will accept such a shift in tax policy given its previous attempts at instituting double dip legislation.
It is difficult to fully judge the effects that these tax law changes would have on a given structure until Canada releases draft legislation, and taxpayers will need significant time to comment on any proposed amendments and to transition to the new regime by winding-up or altering their current arrangements. It would generally be expected that some form of transitional period would be granted for such changes, but this too will only be known once the Department of Finance Canada releases more information on its response to the OECD’s recommendations.

We will continue to monitor developments in this area.

KPMG webcast

KPMG Canada is holding a webcast on April 17, 2014 that will provide an insightful discussion and analysis on international hybrid mismatch financing arrangements and other recent OECD developments that affect your business. This webcast will also highlight new discussion papers, public consultations and recommendations for change to the OECD Model Tax Convention, the Transfer Pricing Guidelines as well as recommendations for changes to domestic laws. In the first part of 2014, the OECD has released discussion drafts on transfer pricing documentation and country-by-country reporting, tax treaty abuse, hybrid mismatch financing arrangements and taxation of the digital economy. By registering for the webcast, you can prepare for the changes proposed by the OECD.

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We can help

Your KPMG adviser can help you assess the potential effect of the BEPS Action Plan on your business, and to prepare for forthcoming changes to the international tax landscape. For more details on this draft and its potential impact, contact your KPMG adviser.