



## **BEPS recommendations on neutralizing negative effects of hybrid mismatch arrangements: importance for Russia**

Regional IFA Conference, Tbilisi  
Levon Ayrapetyan

# Introduction

# Introduction



1



## **The report**

In autumn 2015 OECD has released final package of BEPS reports including report on Action 2 "Neutralising the Effects of Hybrid Mismatch Arrangements" which contains recommendations on changes to domestic law and to Model Tax Convention on Income and on Capital.



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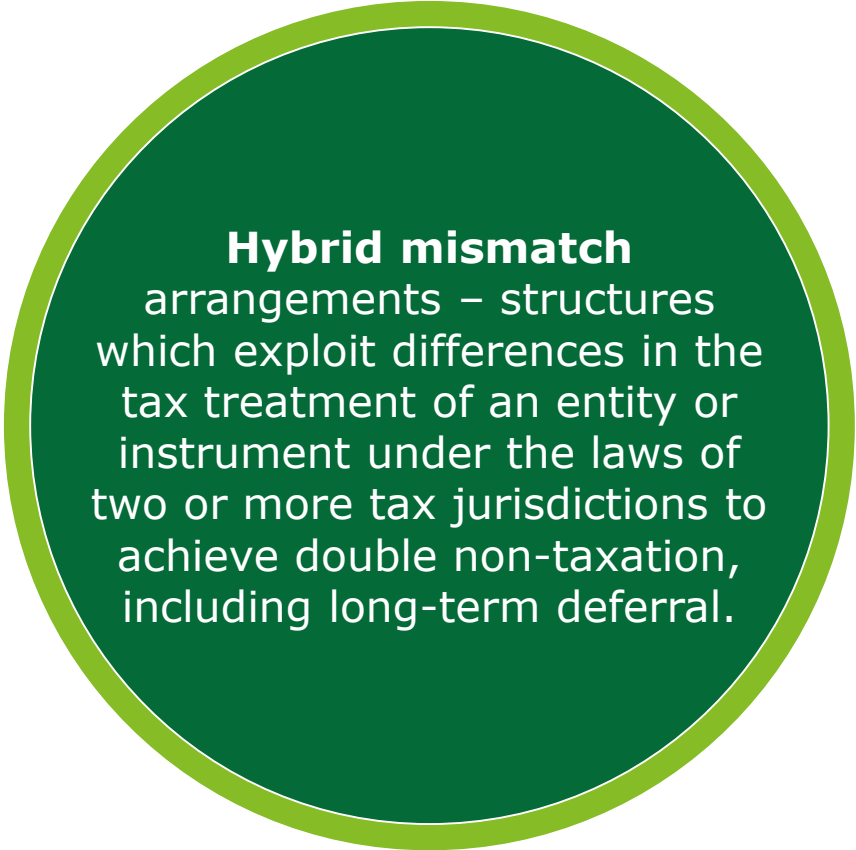
## **Purpose of the report**

The purpose of BEPS Action 2 recommendations is to neutralize negative effects arising due to application of hybrid mismatch arrangements by taxpayers.

# What the “hybrid mismatch arrangement” is?

BEPS Action 2 contains both general definition of hybrid mismatch arrangements and detailed definitions of each particular type of hybrid mismatch arrangement.

Below you may find the general definition:



**Hybrid mismatch**  
arrangements – structures  
which exploit differences in the  
tax treatment of an entity or  
instrument under the laws of  
two or more tax jurisdictions to  
achieve double non-taxation,  
including long-term deferral.

# Why hybrid mismatch arrangements are «bad»?

In 2012 OECD have outlined the following possible negative effects of application of hybrid mismatch arrangements by taxpayers:

**1**

**Decrease of tax revenue**

**2**

**Negative impact on competition**

**3**

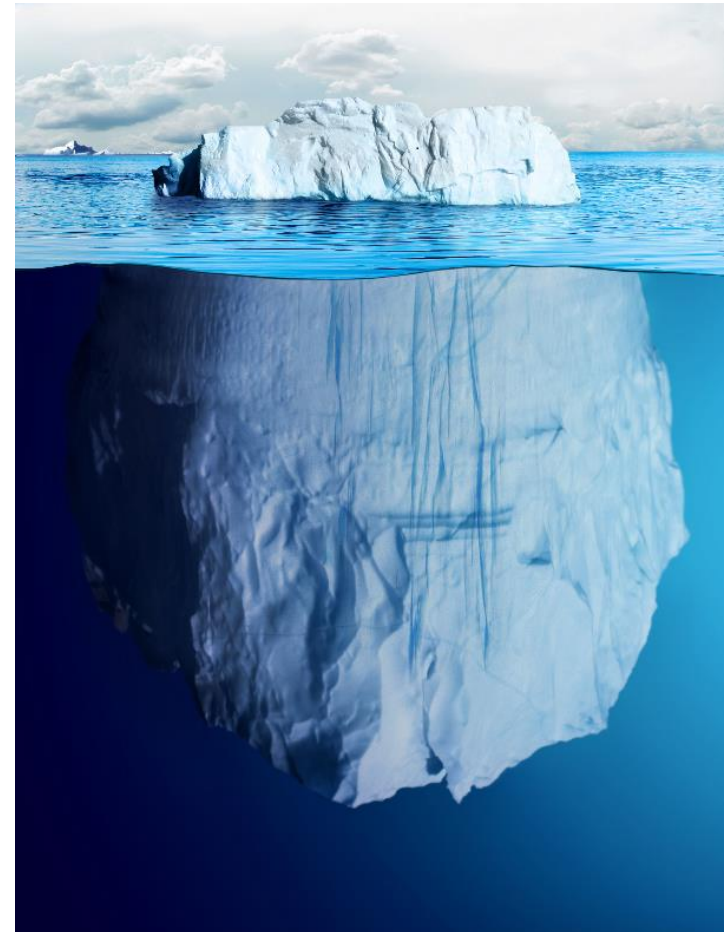
**Decrease of economic efficiency**

**4**

**Negative impact on transparency**

**5**

**Violation of fairness principle**



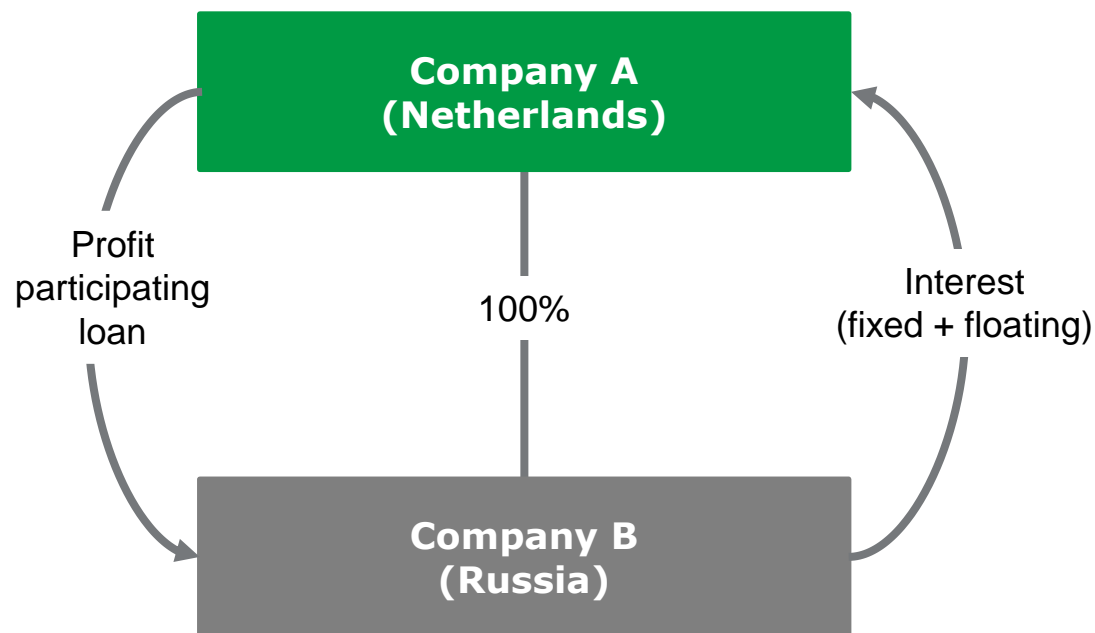
# What does OECD recommends in order to neutralize negative effects of hybrid mismatch arrangements?

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
Deduction / not inclusion outcome	Hybrid financial instrument	No dividend exemption for deductible payments.  Proportionate limitation of withholding tax credits.	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Controlled group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime.  Restricting tax transparency of intermediate entities where nonresident investors treat the entity as opaque	Deny payer deduction		Controlled group and structured arrangements
Double deduction outcome	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response; defensive rule applies to controlled group and structured arrangements
	Deductible payment made by a dual resident		Deny resident deduction		No limitation on response
Indirect deduction / not inclusion outcome	Imported mismatch arrangements		Deny payer deduction		Members of a controlled group and structured arrangements

Is the problem of application of hybrid mismatch arrangements applicable to Russia?

# Hybrid mismatch arrangements applicable to Russia

## Example 1: Cross-border profit participating loan (1/3)



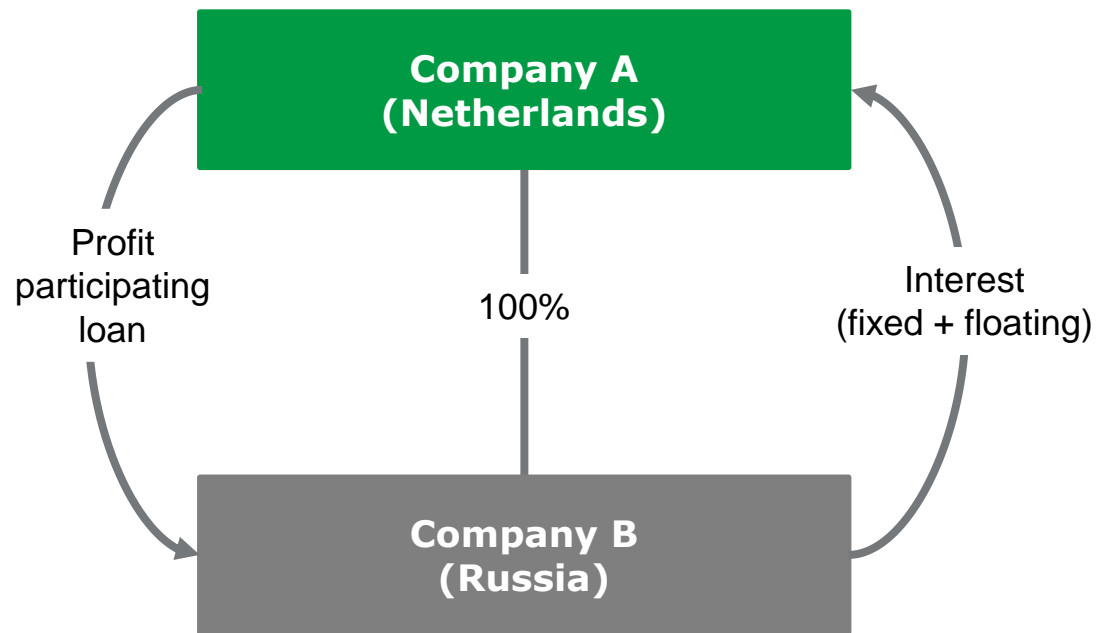
### Facts of the example:

- Company A owns 100% shares of Company B
- Company A have granted a profit participating loan to Company B, under terms of which there is small fixed interest and significant floating interest calculated based on after tax net profit of Company B.
- Period of the loan – 40 years.
- Russian domestic law treats interest on such loan as **tax deductible interest expenses** of Company B (subject to Russian “thin capitalization rules”).
- Dutch domestic law treats “floating” share of interest income as **dividends** received by Company A **subject to participation exemption** (which means such dividends are effectively not taxed in the Netherlands).



# Hybrid mismatch arrangements applicable to Russia

## Example 1: Cross-border profit participating loan (2/3)



### Tax consequences:

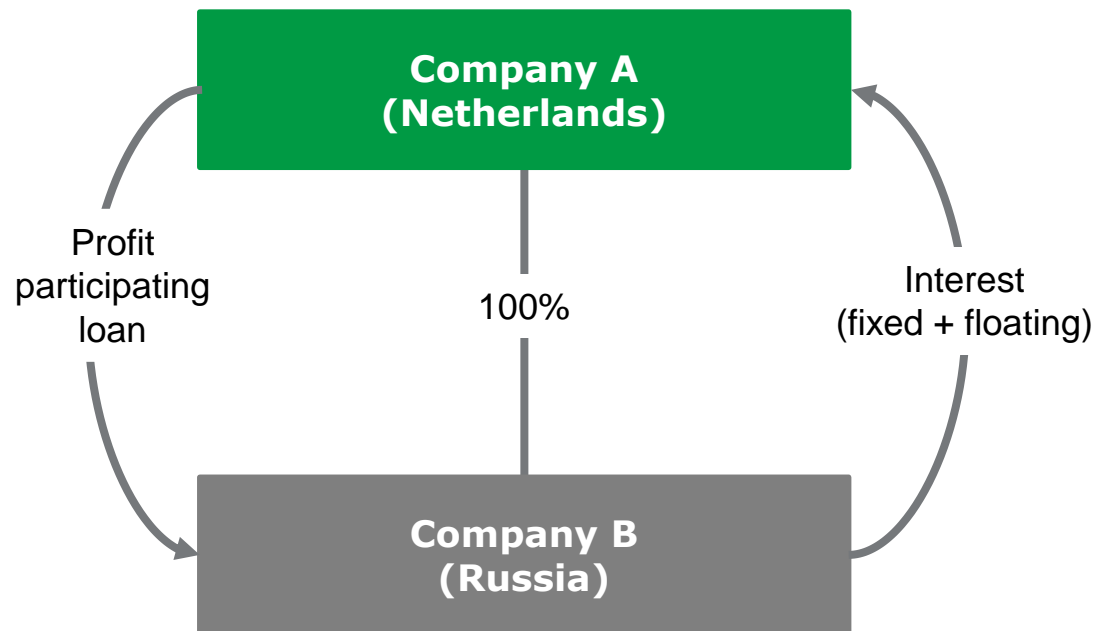
- Tax base of Company B in Russia is reduced by amount of interest paid to Company A (assume that restrictions of Russian “thin capitalization rules” are met).
- “Floating” share of interest income received by Company A is treated as dividends according to Dutch domestic law.
- Dividends received by Company A are subject to participation exemption and therefore are effectively not taxed in the Netherlands.

### Result:

- Interest paid from Russia will not be taxed neither in Russia nor in the Netherlands.

# Hybrid mismatch arrangements applicable to Russia

## Example 1: Cross-border profit participating loan (3/3)

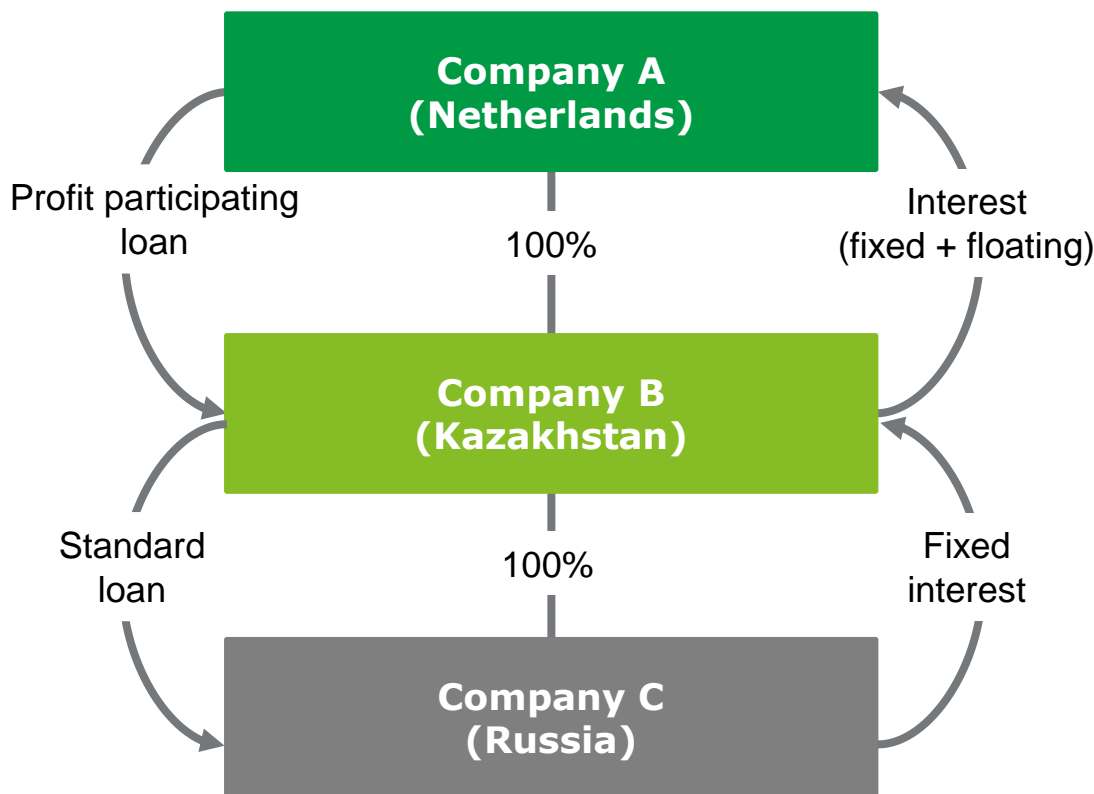


### Importance of the example for Russia:

- The problem of application by taxpayers of so called “hybrid financial instruments” (which themselves are type of hybrid mismatch arrangements) may be applicable to Russia.
- According to BEPS Action 2 in this example Russia will have prioritized (in comparison with the Netherlands) right to deny deduction of interest expenses for Company B in Russia.

# Hybrid mismatch arrangements applicable to Russia

## Example 2: Cross-border on-lending chain of standard loan and profit participating loan (1/3)



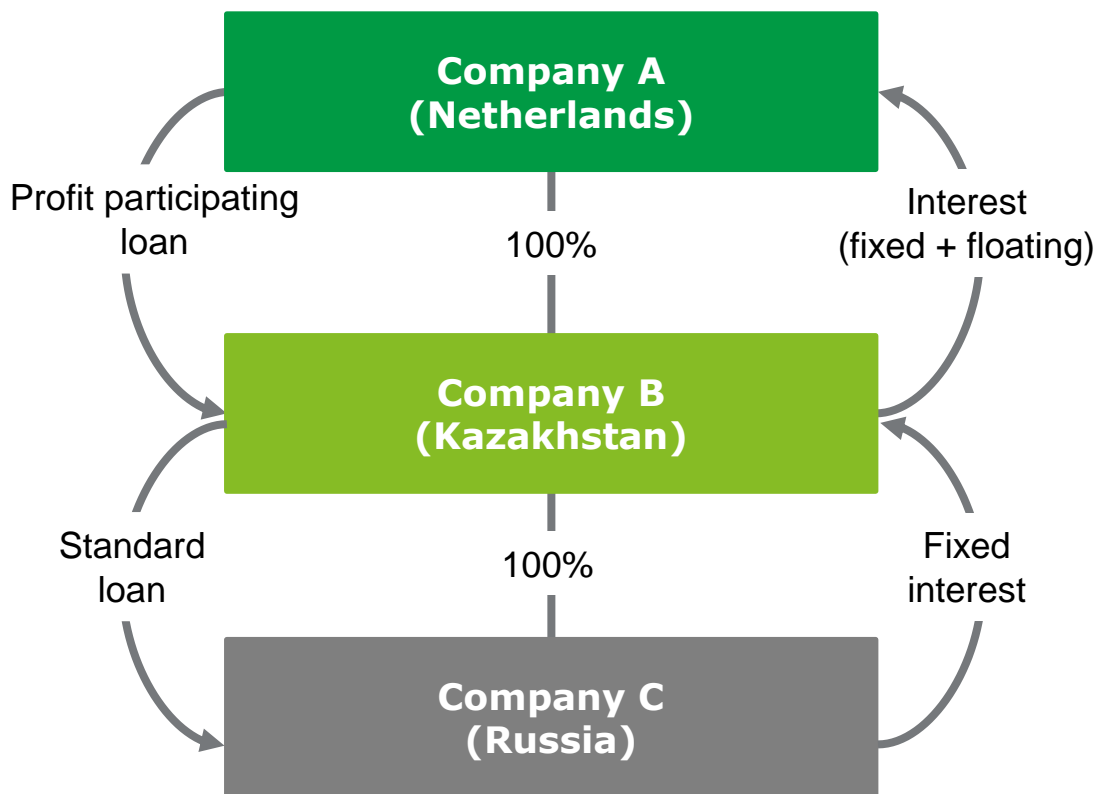
### Facts of the example:

Facts are the same as in Example 1, but:

- Profit participating loan is granted to Company B, which is a tax resident in Kazakhstan.
- Company B owns 100% shares of Company C.
- Company B have granted a standard loan to Company C, under terms of which there is only a fixed interest.
- The amount and period of the standard loan are the same as under the terms of profit participating loan granted to Company B.
- Russian domestic law treats interest on standard loan as **tax deductible interest expenses** of Company C (subject to Russian “thin capitalization rules”).
- Kazakhstani domestic law treats interest on standard loan as **taxable income** of Company B.
- Neither the Netherlands nor Kazakhstan have implemented any applicable BEPS Action 2 recommendations.

# Hybrid mismatch arrangements applicable to Russia

## Example 2: Cross-border on-lending chain of standard loan and profit participating loan (2/3)



### Tax consequences:

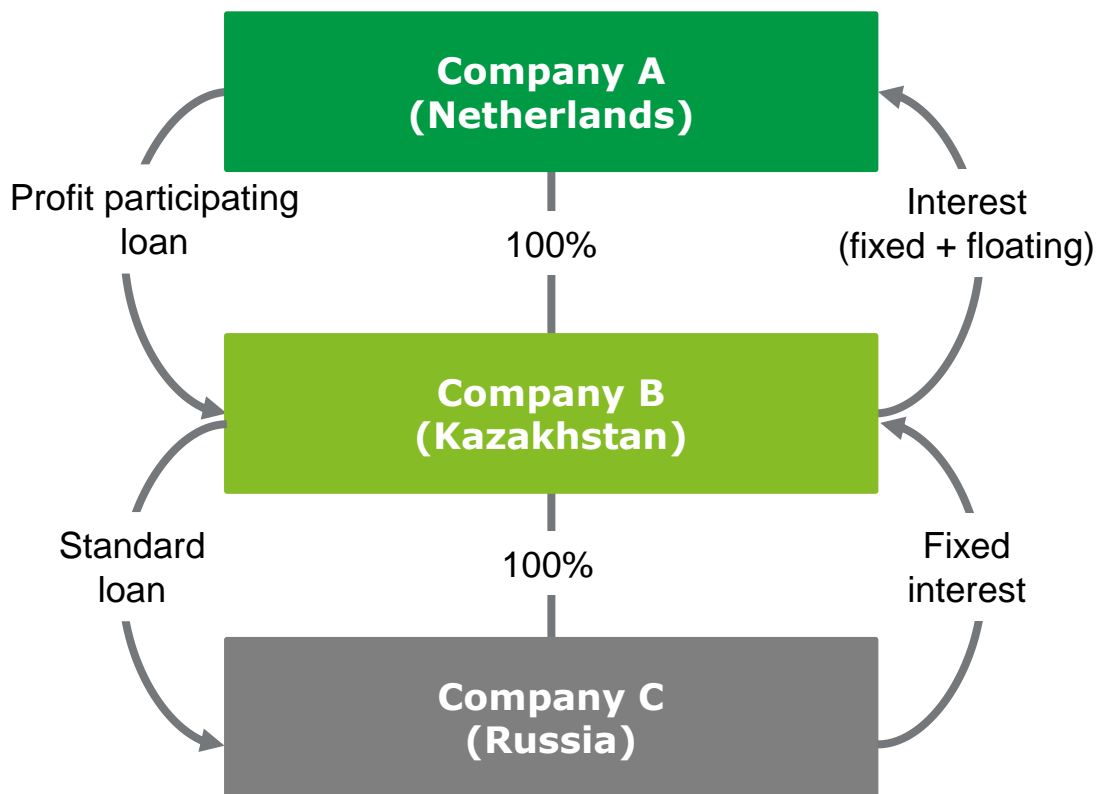
- Tax base of Company C in Russia is reduced by the amount of interest paid to Company B (assume that restrictions of Russian “thin capitalization rules” are met).
- Income received by Company B is treated as taxable interest income in Kazakhstan and included in a tax base of Company B.
- Tax base of Company B in Kazakhstan is reduced by the amount of interest paid to Company A.
- “Floating” share of interest income received by Company A is treated as dividends according to Dutch domestic law.
- Dividends received by Company A are subject to participation exemption and therefore are effectively not taxed in the Netherlands.

### Result:

- Effectively, interest paid from Russia will not be taxed neither in Russia, nor in Kazakhstan and the Netherlands.

# Hybrid mismatch arrangements applicable to Russia

## Example 2: Cross-border on-lending chain of standard loan and profit participating loan (3/3)



### Importance of the example for Russia:

- Russian entities may act as participants in hybrid mismatch arrangements through application of hybrid financial instruments even if direct relationships between Russian and foreign entity (in this example – Kazakhstani entity) do not constitute a hybrid mismatch arrangement.
- According to BEPS Action 2 in this example Russia has a right to deny deduction of interest expenses for Company C in Russia if neither Kazakhstan nor the Netherlands have implemented applicable recommendations of BEPS Action 2 in their domestic law.

Are there any existing regulations in Russia which allow to neutralize negative effects of hybrid mismatch arrangements?

# Status of existing regulations in Russia allowing to neutralize negative effects of hybrid mismatch arrangements

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule	
			Response	Defensive rule
Deduction / not inclusion outcome	Hybrid financial instrument	No dividend exemption for deductible payments. <b>No</b>  Proportionate limitation of withholding tax credits. <b>No</b>	Deny payer deduction. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>	Include as ordinary income. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>
	Disregarded payment made by a hybrid		Deny payer deduction. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>	Include as ordinary income. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>
	Payment made to a reverse hybrid	Improvements to offshore investment regime. <b>- Yes</b>  Restricting tax transparency of intermediate entities where nonresident investors treat the entity as opaque <b>- No</b>	Deny payer deduction. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>	
Double deduction outcome	Deductible payment made by a hybrid		Deny parent deduction. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>	Deny payer deduction. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>
	Deductible payment made by a dual resident		Deny resident deduction. <b>Neither standard nor enforcement rules.</b>	
Indirect deduction / not inclusion outcome	Imported mismatch arrangements		Deny payer deduction. <b>No standard rule. Only through application of "unjustified tax benefit" concept.</b>	

# What can be expected in Russia?

## Introduction of special anti-hybrid rules in the Russian tax law

Since currently Russian tax law does not contain any specific anti-hybrids provisions it may be reasonable for Russia to introduce those of them which will neutralize the most common for Russia hybrid mismatch arrangements.

## High level of uncertainty

As long as dealing with hybrids in Russia is not a common widely spread task for Russian tax authorities it is unexpected what approach will be chosen by them to fight against hybrids in Russia.

For example, what outcomes of application of “unjustified benefit” concept should be expected?

## Uncertain scope of potential Russian anti-hybrid rules

If Russia will introduce anti-hybrid provisions in its tax law, it may either follow OECD’s approach to neutralize only hybrids between affiliated/related parties or apply these new anti-avoidance rules to all transactions, including market transactions between independent taxpayers.





# Conclusions

## **Is the problem of application of hybrid mismatch arrangements applicable to Russia?**

- Yes, certain cases of application of hybrid mismatch arrangements by taxpayers described in BEPS Action 2 may be applicable to Russia.

## **Are there any existing instruments in Russia which allow to neutralize negative effects of hybrid mismatch arrangements?**

- Currently Russian tax law does not contain any standard rules neutralizing negative effects of hybrid mismatch arrangements.
- However, certain mismatch arrangements may be neutralized by Russian tax authorities in enforcement manner through application of “unjustified tax benefit” concept.

## **What can be expected in Russia?**

- There is a certain probability that sooner or later Russia will follow OECD and EU countries and will introduce special anti-hybrid rules in its tax law.
- However, currently there is a high level of uncertainty about approach of Russian tax authorities in the fight against hybrids both in the absence of special rules and after their introduction.



# Q&A session