# ACTION ITEM 2: NEUTRALIZING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

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On the heels of the discussion drafts issued in March, the Organization for Economic Cooperation and Development ("O.E.C.D.") released the initial components of its plan to fight base erosion and profit shifting (the "B.E.P.S. Action Plan"). Action Item 2 addresses the effects of hybrid mismatch arrangements and proposes plans to neutralize the tax deficits caused.

These responses aim to tackle the following issues created by the hybrid mismatch arrangements:[14]

- Reduction in overall tax revenue,
- Unfair advantage given to multinational taxpayers with access to sophisticated tax-planning expertise, and
- Increased expense often incurred in setting up hybrid arrangements compared to domestic structures.

This article introduces the different hybrid arrangements, looks at the proposed changes in both domestic law and international tax treaties, and discusses the ripple effect this could have if implemented.

## INTRODUCTION

A hybrid mismatch arrangement is one that exploits a difference in the way an entity or instrument is taxed under different jurisdictions to yield a mismatch in total tax liability incurred by the parties.[15] The two possible mismatches that could result are either a "double deduction" ("DD") or a deduction that is not offset in any jurisdiction by ordinary income ("D/NI"). These mismatches are brought about by the different interpretations afforded to the entities and transactions in relevant

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[14] IFA, "Hybrid Mismatch Arrangements," February 21, 2013, http://www.ifausa.org/dman/Document.phx?cmd=download&documentId=se05413101027678.

[15] OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. *http://dx.doi.org/10.1787/9789264218819-en*, pg. 29, #41.

jurisdictions. The root cause of the hybrid mismatch is that an entity may be a "hybrid entity" and an instrument may be a "hybrid instrument." Understanding the different hybrid arrangements is instrumental to understanding the plan proposed by the O.E.C.D.

**Hybrid Financial Instruments**

A hybrid financial instrument is an instrument that can be construed as either a debt instrument or a class of equity such as preferred shares, depending on the rules in force in a country. The transaction using the instrument involves two or more countries having different rules in effect, and the terms of the instrument are sufficient to bring about such a mismatch in tax outcomes.[16]

The most common example of this is a debt/equity instrument: a loan from an entity ("A") in Country A to an entity ("B") in Country B where A treats the instrument as equity and B treats it as debt:

- B is granted a deduction on interest payments because the loan is treated as debt.

- A isn't taxed or offered tax relief such as an exemption or an indirect foreign credit – meaning that taxes paid by the borrower in Country B may offset tax owed by A on the receipt of income from countries outside A – in connection with the interest received from B. This presumes that A is a 10% or greater shareholder of B.

Determining whether an instrument is debt or equity can have a significant impact on tax consequences for the borrower and the lender. Well advised companies can negate home-country tax through the foreign taxes paid by subsidiaries when dividends from the subsidiaries are received. If the subsidiary can reduce its own tax with a deduction because the dividend is afforded interest treatment, a D/NI result is achieved. The U.S. has been dealing with tricky debt-equity cases for years; the three most exemplary cases being *PepsiCo* (2012),[17] *Dixie Dairies* (1980),[18] and *Monon Railroad* (1970):[19]

- The court in *Monon Railroad* held that an instrument constituted debt notwithstanding a long maturity term and contingent timing for interest payments.

- The *Dixie Dairies* case established a list of thirteen factors used to determine whether an instrument constitutes a debt or equity.[20]

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16 Neutralising the Effects of Hybrid Mismatch Arrangements, p. 30.
17 *Pepsico Puerto Rico, Inc. v. Commissioner*, T.C. Memo 2012-269.
18 *Dixie Dairies Corp. v. Commr.*, 74 T.C. 476 (1980).
19 *Monon Railroad v. Commr.*, 55 T.C. 345 (1970).
20 See http://www.aicpa.org/Publications/TaxAdviser/2013/February/Pages/clinic-story-01.aspx?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed:+AICPA_TaxAdvisor+(AICPA+Tax+Adviser+Feed)?action=print.

- The *PepsiCo* case is the most recent case to deal with the issue. PepsiCo was a Dutch L.L.C. wholly owned by the PepsiCo Inc. in the U.S. PepsiCo Inc. wanted to treat the agreement between the two companies as debt in the Netherlands and equity in the U.S. for a double tax exemption. The court applied the *Dixie Dairies* factors to determine that the instrument should be treated as equity for U.S. federal income tax purposes.

Despite the fact that all thirteen *Dixie Dairies* factors were applied, two seemed to hold more weight than the others. The first was the degree of certainty regarding repayment of principal and payment of interest, as of the date of issue. As certainty wanes, the instrument begins to look more and more like equity. A second factor was whether the funds were used to acquire core capital assets of the business. If so, the advanced funds are characterized more as equity than debt. On the other hand, if the capital is used for day-to-day expenses, it would weigh towards debt.[21] Note that in all cases the U.S. acknowledges that no single factor is controlling and the importance of the two factors could be different if other circumstances were to exist.

This was also seen in *Hewlett-Packard* (2012),[22] a case involving a put option between a U.S. taxpayer and a foreign corporation. The put option was to all the shares of a Dutch entity in which the U.S. taxpayer was a minority shareholder and the foreign corporation held significantly more shares. The U.S. taxpayer was entitled to put the shares of the Dutch entity to the foreign corporation on specified dates in return for the fair market value on that date. The U.S. taxpayer held certain enforcement rights against the Dutch entity, presumably to force a redemption of its shares by the Dutch entity. The court held that the option instrument was, in substance, debt. According to the court, the key to this determination is primarily the taxpayer's actual intent, as revealed by the circumstances and conditions of the transaction.

Luxembourg offers two such hybrid planning options regarding instruments. One is the Convertible Preferred Equity Certificate ("C.P.E.C."), which is structured to be debt in Luxembourg but equity in the U.S. Another planning option is a profit participating loan which also has the same effect – it is treated as debt in Luxembourg and equity in the U.S.[23] Luxembourg's cooperation, or lack thereof, is what makes it difficult for the I.R.S. to fight the D/NI outcome. If Luxembourg were to decide that payments on these instruments are not deductible, the D/NI treatment would disappear. The lender would not enjoy the tax "kicker" that enhances interest income.

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21 Joe Dalton, "Has PepsiCo's US Tax Court win revealed 'super factor' in deciding debt vs equity cases?," *International Tax Review*, October 4, 2012, http://www.internationaltaxreview.com/Article/3098235/Has-PepsiCos-US-Tax-Court-win-revealed-super-factor-in-deciding-debt-vs-equity-cases.html.

22 Hewlett-Packard Company v. Commr., T.C. Memo 2012-135.

23 Jasper L. (Jack) Cummings, Jr. and Edward Tanenbaum, "Convertivble Preferre Equity Certificates," *Alston & Bird Tax Blog*, July 13, 2011, http://www.alstontax.com/convertible-preferred-equity-certificates/.

Action Item 2 aligns the treatment of cross-border payments so that they are treated as a financing expense by the issuer's jurisdiction and ordinary income in the jurisdiction of the holder.[24]

**Hybrid Transfer**

A hybrid transfer is a collateralized loan arrangement or a derivative transaction in which each of the counterparties are in different jurisdictions and each treats itself as the owner of the loan collateral.[25]

This is clearly seen in sale and repurchase arrangements: A sells its shares in B2 to B with an agreement to repurchase later down the line. A treats the transaction as a collateralized borrowing and any dividends paid to B are treated by A as an interest cost. B treats the transaction as the purchase of participation. Consequently, the dividends B receives from B2 are exempt. A D/NI result is achieved as A's deduction is not matched by the recognition of taxable income by B.

Action Item 2 proposes to neutralize the tax benefit through the following recommendation: Jurisdictions that relieve economic double taxation by offering a dividend exemption for amounts paid by a foreign payor should limit the benefit when the dividend is paid by a company resident in a foreign jurisdiction and is deductible for the payor in that other jurisdiction.

**Hybrid Entity Payments**

Hybrid entity payments create a D/NI situation where the entity is transparent in the payee jurisdiction but not under the laws of the payor jurisdiction.

An entity is transparent with regard to an income item or expense if the laws of a relevant country provide that the entity should be treated as an extension of its sole shareholder. To illustrate: A owns all the shares in B, an entity that is treated as a branch or an extension of A for purposes of Country A tax. In other words, it is a disregarded entity for tax purposes in Country A. In Country B, B is a taxpayer. A makes a loan to B and receives interest income.

For purposes of computing A's taxable income in Country A, the interest is disregarded – A cannot pay interest to itself.

For purposes of computing B's taxable income in Country B, the interest is recognized as an item of income and expense for tax purposes. The interest payment is deductible. Implicit in this example is the absence of an obligation imposed on B under the laws of Country B to collect withholding tax on the interest payment. Either Country B's domestic law does not provide for withholding tax on interest or an income tax treaty between Country A and Country B exempts the interest income of A from tax in Country B.

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[24] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 31.
[25] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 34.

Action Item 2 proposes to neutralize the tax benefit of the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument. The primary response would be to deny the payor a deduction for payments made under the hybrid financial instrument. If a deduction is allowed in the payor's residence jurisdiction, the recipient's jurisdiction would treat the recipient as fully taxable income. The rule does not apply to payments that are fully taxable in both jurisdictions or to mismatches in the recognition of income and expense in the payor's and payee's jurisdictions of residence.

**Reverse Hybrids**

Reverse hybrid entity payments occur where the entity is transparent in the payee jurisdiction but not under the laws of jurisdictions relevant to the payor.[26] In other words, when looking from the subsidiary up to the shareholder/payee, the subsidiary is transparent in its resident jurisdiction (*i.e.*, it is viewed as a part of the shareholder/payee). However, in the payee's jurisdiction, the foreign subsidiary is opaque, meaning it is recognized as an entity that qualifies for benefits because of the payee's status as an owner.[27]

To illustrate: A is the shareholder/payee and B is the subsidiary/payor. B is transparent under the tax laws of Country B but opaque in Country A. B makes a loan to an unrelated entity ("C") and pays interest on the money borrowed:

- The payment is deductible for C under the laws of Country C.
- Owing to the way the loan is structured or booked, in country A, the loan is viewed as income of B.
- Also due to the way the loan is structured or booked, in country B, the loan is viewed as income of A.

*"Action Item 2 proposes to neutralize the tax benefit of the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument."*

Thus, neither Country A nor Country B treats the interest as income of a resident. Each set of laws attributes the income to a resident of another country.

The response recommended in Action Item 2 is to neutralize the effect of hybrid mismatches that arise under payments made to reverse hybrids through the adoption of a linking rule that denies a deduction for such payments to the extent they give rise to a D/NI outcome. The proposed adoption of an offshore investment regime for C.F.C.'s would call for taxation on a current basis of income accrued through offshore investment structures to occur in the shareholder's jurisdiction.[28]

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[26] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 45.
[27] See http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2001/0111c894.authcheckdam.pdf, p. 3.
[28] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 47.

**Indirect Hybrid Mismatches**
Hybrid mismatches can be imported into a jurisdiction of choice through the use of straightforward financial instruments such as loans.

To illustrate: An entity ("A") is a resident of Country A. It intends to make a loan to a related party ("C"), resident in Country C. Instead of making a direct loan to C, it lends money to its subsidiary ("B") pursuant to a hybrid instrument that is viewed to be debt under the tax laws of B's resident jurisdiction, but equity under the tax laws of Country A. B enters into a straightforward lending transaction with C. The ultimate result is a deduction for C and no offsetting of income to B – because of the back-to-back funding transaction with A, which is respected as debt – and no offsetting of income to A – because of the hybrid nature of the loan to B. In substance, the hybrid nature of a parent-subsidiary loan can be extended to a transaction with an unrelated party.

The response of Action Item 2 is to apply the hybrid mismatch rule discussed above in the jurisdiction of residence of C. Again, the effect of timing differences would be ignored. The rule would apply to situations in which all participants are related parties – A, B, and C are in the same group – and situations involving unrelated parties – A and B are related, but C is not – that are acting in concert pursuant to an overall arrangement.

## PROPOSAL

To date, the provisions of U.S. tax law that deal with hybrid mismatch include Code §894, §909, and several income tax treaties that exclude income from hybrid transactions from treaty coverage. Code §894, when applicable, prevents taxpayers from taking advantage of withholding tax reductions through tax treaties when the claim for relief is made by the ultimate investor acting through the hybrid entity. It denies treaty benefits to the ultimate investor if the tax laws of its country of residence treat the hybrid entity as a recognized entity.[29] Section 909 'splitter' rules don't allow foreign credits without a corresponding income inclusion.[30] Paragraph 7 (a) of Article 4 (Residence) of the Canada-U.S. Income Tax Treaty extends the rule to business profits. Paragraph 3 of Article 4 Residence of the France-U.S. Income Tax Treaty ignores the hybrid nature of a third-country instrument used by a U.S. company if the third country has not concluded an agreement containing an exchange or information provision. However, none of these measures have been proven to be thorough enough, and therefore, the O.E.C.D. has put forward Action Item 2.

For a rule to effectively address the mismatches and tackle them head-on, it has to be comprehensive and automatic. However, it must also be coordinated enough to avoid a D/NI result, as well as double taxation on the same item of income. The

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29 Jeffrey Rubinger, "Tax Planning for 'Inbound' Licensing of Intellectual Property," May 12, 2011, http://www.ttn-taxation.net/pdfs/Speeches_Miami_2011/01-JeffreyRubinger.pdf, slide 8.

30 IFA, "Hybrid Mismatch Arrangements," February 21, 2013, http://www.ifausa.org/dman/Document.phx?cmd=download&documentId=se05413101027678, slide 32.

“All cases of dual treaty residence would be solved on a case-by-case basis by the Competent Authorities, rather than on the basis of the current rule that is self-applied.”

rule must be clear and workable in eliminating the mismatch. The planned response is two-pronged: changes to domestic law in member states and treaty applications.

**Domestic Law**

Action Item 2 recommends adoption of a linking rule that aligns tax consequences for payors and payees under the hybrid arrangements. This rule has been discussed above and focuses on a two-step response:

- A more offensive, primary response that denies the deductions to the payors;
- And where the payor is in a jurisdiction that doesn’t apply the primary rule, the payee jurisdiction should apply a defensive rule that would require the deductible payments to be included in ordinary income.

These mismatch rules would apply to related parties of structured arrangements.

**O.E.C.D. Model Tax Convention**

In addition to changes in domestic law, Action Item 2encourages countries to co-operate by sharing data and following the prescribed treatment for dealing with hybrids:

- Collaboratively determine the tax residency of the entity in question to properly determine the tax consequence.[31] This means that all cases of dual treaty residence would be solved on a case-by-case basis by the Competent Authorities, rather than on the basis of the current rule that is self-applied. In the absence of an agreement by the Competent Authorities, the entity would not be entitled to any relief or exemption from tax provided by treaty.
- The income of wholly- or partly-transparent entities would be considered to be income of a resident of a State only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.[32]
- Individuals and entities should be taxed appropriately.

**Scope**

The linking rule cannot be limitless and should not apply to transactions where the hybrid result is a coincidence. Therefore, the O.E.C.D. recommends applying the rule only to mismatches arising between related parties who may be acting in concert.

[31] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 81.
[32] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 86.

A related party is a person who acts together with another person in respect of ownership, control, voting rights, or equity if he or she has an owning or controlling interest. In addition, family members, managing parties, and a person acting in accordance the wishes of another, are all treated as if they were acting together.

## THE BALANCING ACT

By their very nature, hybrid mismatch arrangements are cross border transactions that manipulate facts in order to find ways to diminish the overall tax liability of the participants. The planned approach is an ambitious one; one that depends on the co-operation of other countries.

Action Item 2 basically requires one country to check another's decisions before imposing its own taxes. However, the procedures that are proposed under Action Item 13, related to intangible transfer pricing, may also be applicable to hybrid instruments. If all transactions are open to all tax authorities, the opportunity to "play" the system is reduced.