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"Tax Arbitrage" with Hybrid Entities: Challenges and Responses

In this article, the author examines some technical issues that would result from the introduction of domestic rules against arrangements involving hybrid entities as called for by the OECD BEPS Action Plan. Such rules would need to comprehensively reflect potential fact patterns in order to avoid over-taxation.

1. Introduction[1]

The purpose of this article is to explore some technical aspects of the introduction of domestic law provisions that Action 2 ("Neutralise the effects of hybrid mismatch arrangements") of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) calls for.[2] Why a state should pioneer the introduction of anti-hybrid rules seems to be a particularly difficult and open question since it is unrealistic that the community of states will achieve a level playing field by introducing harmonized anti-hybrid rules. One may well expect at least some states to make a decision not to act if they believe that anti-hybrid rules are apt to put their own industry or inbound investments at a disadvantage.

Effects of hybrid mismatch arrangements caused by hybrid instruments are not within the scope of this article. Neither is a detailed discussion of macroeconomic or political considerations.

The aim of Action 2 is to:

> Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.

In the OECD Report on Hybrid Mismatch Arrangements,[3] hybrid entities are described as:

> Entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.

A different qualification of entities can obviously lead to theoretical and practical difficulties in their taxation and in the taxation of their shareholders. It may also lead to unintended international double taxation or double non-taxation. The latter has caused international concern and has resulted in calls for action.

The potential effects of using hybrid entities, as described in the OECD Report on Hybrid Mismatch Arrangements are:

- Double deduction schemes: arrangements where a – deduction related to the same contractual obligation is claimed for income tax purposes in two different countries.
- Deduction / non-inclusion schemes: arrangements that create a deduction in one country, typically a deduction for interest expenses, but avoid a corresponding inclusion in the taxable income in another country.[4]

However, the issue of double taxation should not be ignored. In particular, countermeasures against double non-taxation should not unintentionally produce additional cases of double taxation.

2. Presumptions

This section outlines the presumptions this article is based on.

Hybrid entities are the result of different policy choices made by sovereign legislators. They are not per se "bad" nor do they per se pose policy questions with regard to BEPS.

An international alignment of the tax treatment of entities is not likely to occur in the foreseeable future.[5] It is unlikely that states can agree on whether partnerships are transparent or opaque entities. An international alignment would also require that certain options (for example, check-the-box rules) are abandoned.

The qualification for tax purposes of a particular entity by its home state is and will not be decisive for all other states. States are unlikely to qualify a foreign entity based on foreign legislative decisions regarding foreign taxation. Finally, the fact that a state would follow the classification of a foreign entity under foreign tax law and disregard the fact that such entity is structurally comparable to some domestic entities or differently qualified foreign entities

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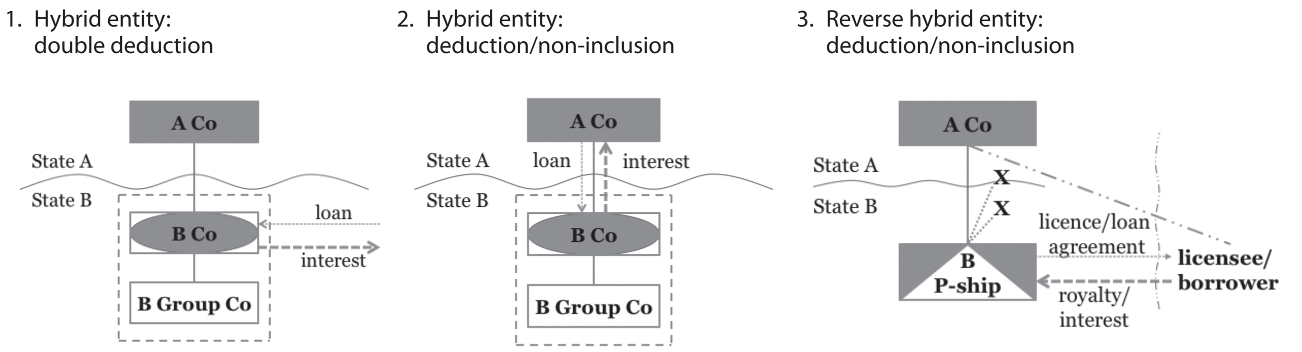
1. The article does not discuss OECD, *Public Discussion Draft BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements* (19 March 12014), available at www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf, which was published after this article was written.
2. OECD, *Action Plan on Base Erosion and Profit Shifting* p. 15 (OECD 2013), International Organizations' Documentation IBFD, also available at www.oecd.org/tax/beps.htm.
3. OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD 2012), International Organizations' Documentation IBFD, also available at www.oecd.org/ctp/aggressive/HYBRIDS_ENG_Final_October2012.pdf.
4. Id., at p. 7. The report states that double deductions may also be achieved by using dual residence entities (p. 8 para. 15).
5. R. Russo, *The OECD Report on Hybrid Mismatch Arrangements*, 67 Bull. Intl. Taxn. 2 (2013), Journals IBFD; S. Bärsch & C. Spengel, *Hybrid Mismatch Arrangements: OECD Recommendations and German Practice*, 67 Bull. Intl. Taxn. 10 (2013), Journals IBFD.

Figure 1: Basic situations involving hybrid entities



in other states would raise questions under the principle of equality.

It follows from the above that countermeasures with regard to hybrid entities are likely to attack the double deduction or deduction/non-inclusion effects rather than the entity qualification as such.

Such countermeasures should be drafted as narrowly and precisely as possible based on a proper consideration of situations which do indeed raise policy concerns. It is important to consider that any countermeasure is a deviation from the "normal" system of the tax law based on rules chosen by a sovereign legislator. These rules are generally independent of other states' laws. Countermeasures need to be drafted in a way which avoids unintended (economic or juridical) double taxation.

Anti-hybrid rules should aim to preclude base erosion and profit shifting that is effected by exploiting mismatches in the tax systems. They should not punish taxpayers for behaviour which is caused by uncoordinated or deficient legislation.

Finally, one should bear in mind that Action 2 is primarily about *permanent* double deductions or deduction/non-inclusion of payments. However, hybrid mismatches often have a *temporary* rather than permanent effect. In order to avoid unintended double taxation as a permanent effect of anti-hybrid rules, these rules generally need to take account of multi-year rather than one-year fact patterns. If a mismatch leads to a long-term deferral and if a legislator chooses to respond to that, the anti-hybrid rule needs to be restricted to combating the deferral effect.

3. BEPS Standard Situations Involving Hybrid Entities

3.1. Introductory remarks

Policy concerns involving hybrid entities can be illustrated by the three basic situations mentioned in the OECD Report on Hybrid Mismatch Arrangements (*see* Figure 1).[6]

In sections 3.2., 3.3. and 3.4., these situations are discussed to show the BEPS-related effects (if any).

3.2. Double deduction of payments made by a hybrid entity

3.2.1. Opening comments

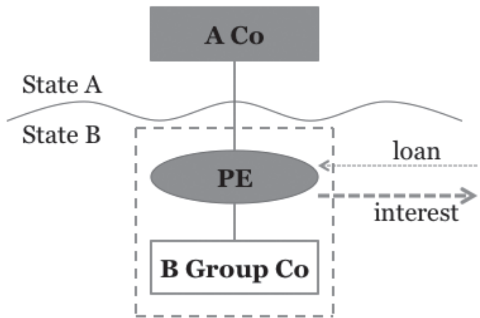
Action 2 of the BEPS Action Plan calls for

> (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction.

Notwithstanding the wide wording, not every deduction of a payment in two jurisdictions requires or justifies the application of an anti-hybrid rule. This may be illustrated by the example in Figure 2.

Figure 2: Basic situation 1

Hybrid entity: double deduction



B Co is a non-transparent entity in State B and a transparent entity in State A. B Co and B Group Co are part of a tax group in State B. B Co pays interest of 100 in year 1 to a third party and has no other significant own income or expenses. B Group Co has positive income of 100, which is accumulated at its level. In year 2, B Co does not pay any interest but earns its own income of 100.

In both years taken together, the combined economic income of all companies amounts to 100.

In year 1, the interest payment is offset at the level of B Co against the positive income of B Group Co under State B's group taxation regime. The payment is also deductible from A Co's other income in State A. The result for year 1 is a deduction of the interest payment in State A and State B (double deduction).

The income of B Co earned in year 2 is taxable in both State A and B. The result for year 2 is taxation of the income of B Co in both State B and A (double taxation).

6. The names of the entities were slightly changed for convenience purposes.

The overall result is an appropriate taxation of the combined economic income of A Co, B Co and B Group Co (100). However, there is a one-year deferral.

At first glance, one might think that the double taxation of the income of 100 in year 2 by States A and B would be avoided by State A if that state granted a foreign tax credit for State B's tax. However, firstly, a tax credit requires that the overall taxable income in both states is positive and actually triggers a tax liability.[7] Secondly and possibly most importantly, State A would grant the foreign tax credit although the foreign total result of years 1 and 2 (derived by B Co itself) is zero; hence, there may well be in place a restriction for such tax credit.[8]

3.2.2. No general concerns with double deduction

The double deduction of the payment in both states in year 1 only raises policy concerns if the income from which the deduction is claimed is not taxable in the other state. Consequently, there are no policy concerns about deducting in State B the payment from other income of B Co, which is taxable in State A as well.

3.2.3. Multi-year approach

It needs to be determined on the basis of a multi-year rather than only the current year's circumstances whether or not a payment is deducted from income which is taxable in both states, irrespective of whether the anti-hybrid rule aims to combat only permanent double deduction effects or also long-term deferrals.

The practical difficulties in observing the development of income elements and deductions in a foreign jurisdiction during a perennial period are obvious. It is also obvious that the relevant rules are likely to be drafted in a form which either does not precisely respond to the theoretical requirements and/or is overly difficult to understand and complicate to administer.

But rules reflecting the multi-year developments are seemingly indispensable. As the overall result of basic situation 1 is an appropriate taxation of the combined economic income of the group, there is no BEPS-related double deduction effect of the payment of B Co which is deducted from A Co's income in State A and from B Group Co's income in State B in year 1 if B Co has other positive income in a later year which is also taxable at A Co level in State A. Hence, if a rule is introduced in either state which denies the deduction of B Co's payment in year 1 but does not take into account that B Co's income in year 2 is taxable at A Co level, an economic double taxation results.

If an anti-hybrid rule is drafted to cover this scenario in an appropriate way, it effectively combats a (short-term) timing difference rather than a true double deduction outcome.

3.2.4. Relevance of different forms of taxation

The indirect taxation by one state of the income against which the payment is set off in the other state needs to be taken into account. Taxable dividends received from group companies and capital gains resulting from the sale of group companies call for exemptions from anti-hybrid rules.

If B Co and B Group Co have no income in year 2 and B Group Co pays its accumulated profit from year 1 in year 2 as a dividend to B Co, the result in year 1 would be the same as that mentioned in section 3.2.1. (double deduction). However, the dividend is taxable at A Co level in State A[9] in year 2 but not taxable at B Co level in State B since the underlying income had been attributed to and taxed by B Co under the group taxation regime already in year 1. No foreign tax credit is available as the income had not triggered an actual tax liability in year 1 due to offsetting of the interest payment. In year 2, there is a taxation of the dividend in State A. Depending on A Co's other income in year 1, this taxation may be matched by a loss carry-forward (from the deduction of the interest paid by B Co at A Co's level) and no actual tax liability is triggered. Alternatively, if the interest has been deducted from other income derived by A Co in year 1, the dividend triggers an actual tax at A Co level (in the absence of a foreign tax credit). The overall tax burden of the combined economic income of zero of the group in the two-year period amounts to zero and is appropriate. However, in the latter alternative, there is a one-year deferral.

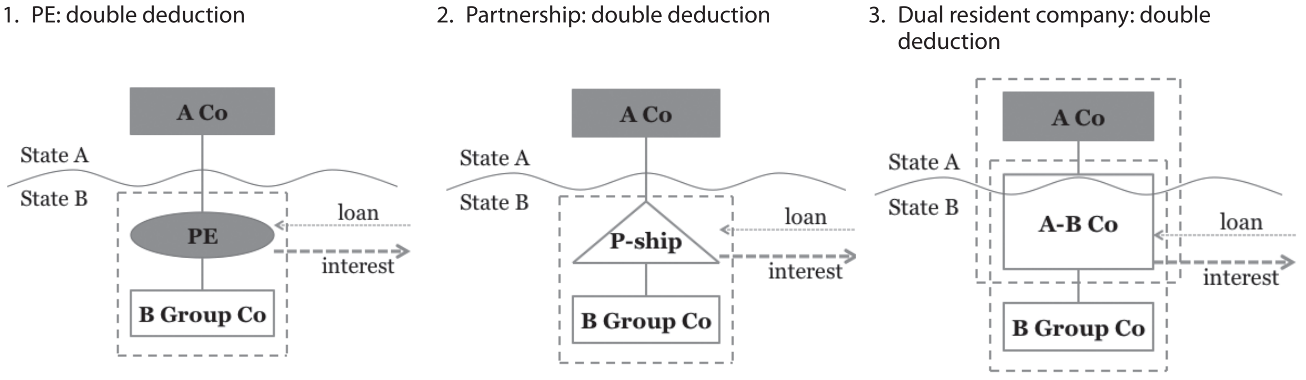
The above example shows that there is no BEPS-related double deduction effect of the payment of B Co which is deducted from B Group Co's income if a dividend paid by B Group Co out of this income is taxable at A Co level in State A. The same is true if, in the absence of such dividend, a respective capital gain upon disposal of the shares in B Group Co in a later year is taxable at A Co level in State A.

Hence, an economic double taxation would result from the introduction (in either state) of a rule which denies the deduction of B Co's payment in year 1 but does not take into account that the income from which the payment is deducted is (indirectly) taxable at A Co level in a later year.

If an anti-hybrid rule is drafted to cover this scenario in an appropriate way, it effectively combats a (short-term) timing difference rather than a true double deduction outcome.

7. If there were no other income in year 1 in State A, A Co would have a loss carry-forward of 100 and would not pay an actual tax on the income of 100 in year 2. Hence, no foreign tax credit could be granted.
8. If there were no such restriction in place, this would also result in an inappropriate tax credit in other situations not involving any hybrid entity. Assume, for example, that a foreign PE of A Co suffers a loss in year 1 and makes a profit in year 2; if there is no loss carry-forward in the PE State there is a risk for State A to grant a foreign tax credit in year 2 although the overall result of the PE is zero.
9. Some states exempt dividends but allow the deduction of related expense. If State A does so, it seems that the result is a final double deduction effect. However, the result is not caused by the hybrid element of the structure but by State A's policy decision to allow said expense deduction. Assume, for example, that A Co holds shares in a subsidiary which are attributed to a PE in State B (no hybrid element). If both states allow the expense deduction, but only State B taxes dividends as A Co's income of the PE, the result is the same.

Figure 3: Other group taxation examples



3.2.5. Group taxation vs hybrid entity qualification

The considerations mentioned in section 3.2.4. show that the double deduction is not primarily caused by the fact that the interest paying entity is a hybrid. Instead, the actual reason for the double deduction outcome is the possibility to offset B Co's expense against income (of B Group Co) which is not taxable in State A as would be the case in the scenarios shown in Figure 3.

The result would be exactly the same if the tax group in State B was headed by a PE of A Co, by a non-hybrid partnership (transparent in both states) or by a dual resident entity, provided these have – equally – no significant other income.

The OECD Report on Corporate Loss Utilisation through Aggressive Tax Planning mentions the above observation in chapter 4 under the headings "Dual-resident companies" and "Branch models".[10] The OECD Hybrid Mismatch Report mentions dual resident companies.[11] Other reports and the BEPS Action Plan no longer refer to this issue.

If the OECD chooses to extend Action 2 to all these forms of group taxation regimes, the recommendation should no longer refer to mismatch arrangements by using hybrid entities. Instead, such a countermeasure would represent a sort of dual consolidated loss rule (the "DCL rule") as applied in some countries in connection with group taxation regimes. DCL rules may be one of the answers to BEPS, but they should not – even not for "political" purposes – be labelled as anti-hybrid rules.

Alternatively, if countermeasures are specifically directed against the use of hybrid entities in combination with a group taxation regime, they may be difficult for the home state of such entity (State B) to defend under the principle of equality. The entity (B Co) is a corporation under State B's tax system. There is no good policy reason or legal justification for denying that entity a deduction of its business expenses if, in a comparable situation, a PE of a foreign entity or a transparent partnership is granted the deduction.

10. OECD, *Corporate Loss Utilisation through Aggressive Tax Planning*, p. 57 et seq. (OECD 2011), available at http://dx.doi.org/10.1787/9789264119222-en.
11. OECD, *supra* n. 3, at p. 15.

3.2.6. Policy options for State A and State B

3.2.6.1. Initial comments

The deduction of the payment is correct and appropriate under both states' tax laws if looked at in isolation, even if there is a final double deduction outcome or a long-term deferral. The deduction may only be denied by either state if the exception from the general principles of its tax system is required for overwhelming and unquestionable reasons.

3.2.6.2. Which state should act?

The BEPS Action Plan states that:

> While it may be difficult to determine which country has in fact lost tax revenue, because the laws of each country involved have been followed, there is a reduction of the overall tax paid by all parties involved as a whole, which harms competition, economic efficiency, transparency and fairness.[12]

Under State B's tax laws, there is a domestic business expense being offset against other taxable income. Such offset is one of the major aims and features of every group taxation regime. For the following reasons, it is difficult to find good policy reasons or justifications to deny such offset if the business expense is incurred by a non-transparent corporation:

– The legislator would restrict its sovereignty if the above tax treatment were made dependent on the qualification of the domestic entity by another state.
– The denial of the offset would increase the tax burden of the corporation and not the tax burden of the related party in the other state.
– Any additional tax burden of the corporation would indirectly hit minority shareholders of the corporation, irrespective of whether they are resident in the other ("transparent") state or not.
– If an offset is not denied for a hybrid entity in State B, one may also question whether there are good reasons for a DCL rule which denies the offset by State B in comparable situations (i.e. if the payment is made by the head of a tax group having the form of a PE, a transparent partnership or a dual resident company).

12. OECD, *supra* n. 2, at p. 15.

Under State A's tax laws, a restriction on deducting the payment might be easier to justify. It is State A which deviates from the qualification of the foreign entity by its home state. The payment, although undoubtedly attributable to A Co under the worldwide tax system, is not a domestic but rather a foreign event. The expense is connected to the business carried on in State B (in the form of a hybrid entity, PE, partnership or a State B PE of the dual resident entity).

3.2.6.3. Basic requirements for anti-hybrid rules[13]

Assume that in basic situation 1 (*see* section 3.2.1.) State A denies the deduction in year 1 under a rule which aims to prevent a double deduction outcome. The result would be an economic "double taxation" of the combined economic income of the group (100), unless the deduction is allowed retroactively for year 1 or on a current basis in year 2, once B Co earns income which is taxable at A Co level in State A.

Alternatively, assume that State B denies the deduction in year 1 under a rule which aims to prevent a double deduction outcome. The result would be again an economic "double taxation" of the combined economic income of the group (100) unless the deduction is allowed retroactively for year 1 or on a current basis in year 2, once B Co earns income which is also taxable at A Co level in State A.

Double taxation would also result in the alternative example to basic situation 1 (*see* section 3.2.4.), unless the deduction is allowed by State A/State B retroactively for year 1, once B Group Co distributes its profits as a dividend which is taxable at A Co level in State A but not at B Co level in State B. Ring-fencing of the interest in year 1 and carrying it forward by State B would not be sufficient in the alternative example as there is not necessarily income to be offset at B Co's level in the later year in which B Group Co pays the dividend.

The same would be true if B Co disposed of its shares in B Group Co before B Group Co pays a dividend or transfers its profit to B Co. Such a disposal would be taxable under State A's tax laws but not under State B's since the capital gain would reflect income which had been attributed to and taxed by B Co under the group taxation regime.

3.2.6.4. Avoidance of "circularly linked" rules

Irrespective of how the rules are drafted in detail, "circularly linked" rules[14] in both states need to be avoided.

Provided that a rule is introduced in State B, the denial of the deduction in State A should prevail (for the underlying reasoning, *see* section 3.2.6.3.). In other words, if such a rule is applied in State A, it should be assumed by law that the deduction is not denied in State B, although a respective rule exists in State B. In State B, in turn, the rule, if any, should be drafted in a way that it will not be applied if a respective rule exists in State A.

3.2.6.5. Difficulties in applying foreign states' tax laws

Apart from the issue of sovereignty, there are significant practical difficulties caused by reference to foreign tax laws.

There is quite a difference between determining the amount of foreign tax to calculate a foreign tax credit or the level of taxation under CFC rules, on one hand, and taking into account the treatment of a payment and other specific parts of income under the rules of a foreign tax system, on the other hand. The former seems easier for taxpayers and tax administrations as it requires less technical understanding about the foreign tax rules and less factual knowledge about the facts and circumstances.

Difficulties may also be experienced by the legislator itself when drafting a rule which refers to details of foreign taxation. German experience shows that collateral damage seems to be almost unavoidable.[15] This applies, for example, to the DCL rules[16] and rules converting tax-exempt income into taxable income, where the corresponding payment is tax deductible (corresponding taxation).[17]

3.2.6.6. Additional observation: double income inclusion

One should note that in the group structures which are discussed in section 3.2., international economic double taxation may occur in a reverse scenario: if B Co has positive income which is simultaneously offset against losses incurred by B Group Co and losses incurred by A Co (double income inclusion), there are normally no rules in place to avoid such a double utilization of losses by the same profit.[18] If states consider introducing a rule against the double deduction effects, they should consider introducing a suitable mechanism for the avoidance of double taxation in reverse situations.

3.3. Deduction/non-inclusion of payments made by a hybrid entity to a shareholder

3.3.1. Opening comments

Action 2 of the BEPS Action Plan calls for

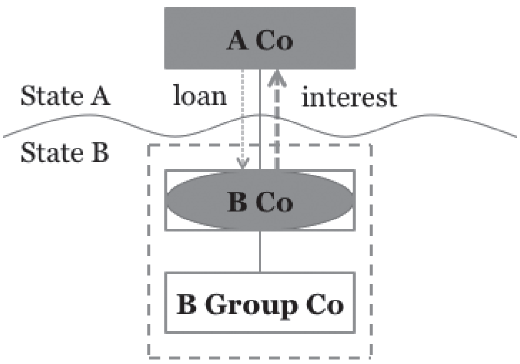
> (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules).

13. Similar basic requirements should be observed when designing DCL rules.
14. For more details, *see* K. Dziurdź, *"Circularly Linked" Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on a Tie-Breaker Test*, 67 Bull. Intl. Taxn. 6 (2013), Journals IBFD; Bärsch & Spengel, *supra* n. 5, at p. 527.
15. J. Lüdicke, *Das Steuerrecht der Unternehmen* in: *Festschrift für Gerrit Frotscher* p. 413 et seq. (Haufe-Lexware 2013); Bärsch & Spengel, *supra* n. 5, at p. 527.
16. DE: Corporate Income Tax Law sec. 14 (1) no. 5 (*Körperschaftsteuergesetz*, KStG), National Legislation IBFD; OECD, *supra* n. 3, at p. 15. The German rules have been tightened by new legislation enacted on 20 February 2013. In contrast to the statement made in OECD, *supra* n. 3, at p. 15, there is no doubt in the German tax literature that the provision is excessive, inappropriately drafted and almost not administrable.
17. Sec. 8b (1) KStG. A previous version of this rule is mentioned in OECD, *supra* n. 3, at, p. 19.
18. Measures to avoid double taxation by granting an ordinary foreign tax credit fail in such situations since there is no actual tax to be credited in the year in which the positive income is taken into account in both states.

Similar to double deduction situations, not every deduction/non-inclusion of a payment in two jurisdictions requires or justifies the application of an anti-hybrid rule. This may be illustrated by the example in Figure 4.

Figure 4: Basic situation 2

Hybrid entity: deduction/non-inclusion



State A regards B Co as transparent. As B Co has only one owner, the loan between A Co and B Co and the interest received by A Co are disregarded under State A's tax laws. Under State B's tax laws, the loan is taken into account. B Co and B Group Co are part of a tax group in State B. In year 1, B Co pays interest of 100 to A Co. B Co has no other income or expenses. B Group Co has income of 100.

Alternative 1: In year 2, B Co has other income of 100, but no interest expense. B Group Co has no income. In both years taken together, the combined economic income of the group amounts to 200.

Alternative 2: In year 2, B Co has no income or expenses. B Group Co pays a dividend of 100 to B Co. In both years taken together, the combined economic income of the group amounts to 100.

The result is that, in year 1 B Co has a taxable income of 0 (100 income of B Group Co minus 100 interest expense). At the level of A Co, the interest payment of 100 is not recognized under State A's tax law as B Co is disregarded. The result for year 1 is a deduction of the interest payment in State B and non-inclusion in State A.

Alternative 1: In year 2, B Co's tax base is 100. A Co's tax base is 100 as well. If State A does not grant a foreign tax credit for the tax paid in State B in year 2, the overall result is an appropriate taxation of the combined economic income of the group of 200 (i.e. neither deduction/non-inclusion effect nor double taxation). If State A grants a foreign tax credit for the tax paid in State B in year 2, this effectively leads to undertaxation. Such tax credit, however, would disregard the fact that, in both years, B Co (on a stand alone basis) has earned a total income of zero under State B's tax laws.[19]

Alternative 2: In year 2, the dividend is taxable at A Co level in State A[20] but not taxable at B Co level in State B since the underlying income has already been attributed to and taxed by B Co in year 1 under the group taxation regime. No foreign tax credit is available in State A as the income had not triggered an actual tax in year 1 due to offsetting of the interest payment. The dividend is taxed in State A in year 2. The overall result is an appropriate taxation of the combined economic income of the group of 100, earned in both years; however, there is a one-year deferral.

3.3.2. *No general concerns with deduction/non-inclusion (multi-year approach)*

The deduction of the payment in one state combined with the non-inclusion in the other state raises policy concerns only if the income from which the deduction is claimed is not taxable in the other state. Consequently, there are no policy concerns regarding deduction of the payment, for State B tax purposes, from other income of B Co which is taxable in State A as well.

Again, a multi-year rather than a one-year only period has to be taken into account.[21]

As can be seen from alternative 1 of basic situation 2, there is no BEPS-related deduction/non-inclusion effect of a payment of B Co to A Co if it is deducted from B Co's income in the same year. Depending on the design of State A's foreign tax credit rules, the same applies if the payment leads to a loss carry-forward which is used in year 2 or in a later year whenever B Co has other positive income.

3.3.3. *Relevance of different forms of taxation*

As with double deduction, the indirect taxation by one state of the income against which the payment is set off in the other state needs to be taken into account.[22] Thus, taxable dividends received from group companies and capital gains resulting from the sale of group companies call for exemptions from anti-hybrid rules.

This can be seen in alternative 2 of basic situation 2. As in year 2, the dividend is taxable at A Co level in State A but no foreign tax credit is available. The overall result is an appropriate taxation of the combined economic income of the group of 100, earned in both years; however, there is a one-year deferral.

As a result, there is no BEPS-related deduction/non-inclusion effect of a payment of B Co to A Co which is deducted from B Group Co's income if a dividend paid by B Group Co out of this income is taxable at A Co level in State A. The same is true if, in the absence of such dividend, a capital gain upon disposal of the shares in B Group Co in a later year is taxable at A Co level in State A.

Hence, if a rule which denies the deduction of B Co's payment in year 1 but does not take into account that income from which the payment is deducted is (indirectly)

19. This effect becomes more obvious if one assumes that B Co earns the other income in the same year in which the interest (subject to deduction/non-inclusion) is paid: The other income is taxable in State A, but there is no State B tax to be credited.

20. For a discussion of a potential exemption of the dividend by State A, *see supra* n. 9.
21. *See* section 3.2.3.
22. *See* section 3.2.4.

taxable at A Co level in a later year is introduced in either state, an economic double taxation results.

If an anti-hybrid rule is drafted to cover this scenario, it effectively combats a (short-term) timing difference rather than a true deduction/non-inclusion outcome.

3.3.4. Policy options for State A and State B

The deduction and the non-inclusion of the payment are correct and appropriate under both states' tax laws if looked at in isolation, even if there is a final deduction/non-inclusion outcome or a long-term deferral. However, the mismatch is clearly caused by State A's tax system. The deduction may, therefore, only be denied by State B if the exception from the general principles of its tax system is required by overwhelming and unquestionable reasons.

Under State B's tax laws, it is difficult to see why B Co, a company set up and resident only in State B, should be denied a deduction of a business expense within the group taxation regime only because of the fact that another state qualifies this entity as a transparent one and does not recognize a contractual obligation with a distinct taxpayer. Under State B's tax laws, it does not matter to which person (here: A Co) the payment is made. This is true as a general tax policy consideration as well as under the ability-to-pay principle. The same considerations with regard to State B's sovereignty and disadvantages for minority shareholders as in double deduction situations (*see* section 3.2.6.2.) would apply here as well.

Under State A's tax laws, an obligation to include the payment might be easier to justify since under State A's tax laws it matters which (foreign) person (here: B Co) makes the payment. Again, it is State A which deviates from the qualification of the foreign entity by its home state.

If legislators choose to introduce anti-hybrid rules, the deliberations with regard to requirements and difficulties when drafting anti-hybrid rules in double deduction situations should be taken into account in cases of deduction/non-inclusion as well (*see* sections 3.2.6.3. to 3.2.6.6.).

3.3.5. Withholding tax

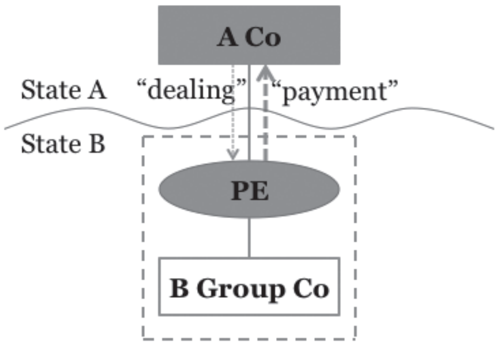
If State B introduces an anti-hybrid rule and denies the deduction of the payment because it is not recognized as A Co's income by State A, State B should refrain from levying a withholding tax for the account of A Co. Such withholding tax would not be credited in State A, as there is no respective income inclusion.

If the payment is ring-fenced by State B and becomes deductible in a later year, the levy of withholding tax might then be justifiable. However, a withholding would no longer be possible (no retroactive withholding tax).

3.3.6. Hybrid entity vs permanent establishment

In contrast to the double deduction situation (*see* section 3.1.4.), a deduction/non-inclusion result cannot be achieved with all potential heads of a tax group. However, the mismatch is not unique to a hybrid entity acting as head of a tax group. A similar effect would occur if, for example, a "dealing" between head office and PE is treated differently by both states.

Figure 5: Dealings between the head office and a PE



In Figure 5, State B accepts a deduction (for example, with regard to a licence fee or an interest payment), whereas State A does not tax the corresponding income.

The deduction/non-inclusion outcome requires a group taxation regime in order to have the possibility to offset the deduction against the income which is not subject to tax in State A.

3.4. Deduction/non-inclusion by using reverse hybrid entities

3.4.1. Opening comments

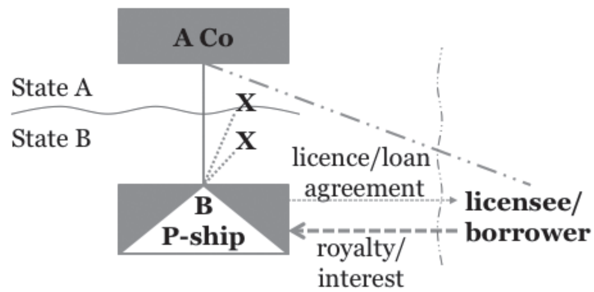
Action 2 of the BEPS Action Plan calls for:

> (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer;
> (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules).

With regard to reverse hybrids, a particular difficulty in applying countermeasures is caused by the fact that the parties in a structure may be unrelated and may not necessarily have sufficient knowledge about all facts and circumstances.

Figure 6: Basic situation 3

Reverse hybrid entity: deduction/non-inclusion



According to basic situation 3 (*see* Figure 6), entity B is transparent for State B's tax purposes (a partnership). If there is no PE in State B to which the royalty/interest income can be attributed, State B is unlikely to tax the income which is attributable to A Co's share in entity B.

State B may, however, tax X's share in entity B unless X is non-resident.

State A, on the other hand, treats entity B as non-transparent and does not tax the income.

The licensee/borrower may be a related or unrelated party and resident in any state (including States A or B).[23]

Although there are BEPS-related concerns with regard to the overall result of the structure, there seem to be no straightforward countermeasures available, except in cases where A Co, B and the licensee/borrower are related parties or act collusively together.

3.4.2. No restriction of the deduction

If the licensee/borrower is not a related party to the hybrid entity, there is no good policy reason or justification to deny its deduction. In addition, this person and the state of its residence may not have sufficient knowledge about the underlying facts. Different considerations may apply if the licensee/borrower is part of the "scheme".

3.4.3. CFC rules in State A

The part of the income derived by B which is attributable to A Co's share in B should be within the ambit of standard CFC rules in State A.

If CFC rules do not exist in State A or if they exist but are not applied, State A might consider introducing or changing them.

The application of CFC rules may not be appropriate if B is not part of A Co's group of companies but rather an investment vehicle in which A Co holds only a minority share.

3.4.4. Other anti-hybrid measures employed by State A

There is no good reason for State A to introduce an anti-hybrid rule (different from CFC rules) under which the income derived by or through B would be taxed.

Taxation of income in the hands of entity B is contrary to the international tax principles since B has no nexus with State A at all. Taxation of income in the hands of A Co is contrary to the basic features of State A's tax system as the income of opaque entities cannot be attributed (except under CFC rules) to other taxpayers.

If the application of CFC rules is inappropriate (because A Co only holds a minority share in B), the introduction by State A of any other anti-hybrid rule (except for a general anti-avoidance rule (GAAR) in the case of collusive behaviour)[24] also seems inappropriate.

3.4.5. Anti-hybrid measures by State B

There is no good reason for State B to introduce an anti-hybrid rule under which the income derived by or through entity B would be taxed.

Taxation of income in the hands of entity B is contrary to the basic features of State B's tax system since B (as a transparent entity) cannot be a taxpayer. Such taxation would need to be restricted to parts of the income which are attributable to foreign owners to whom such income is not attributed under the tax laws of *any* other state (neither directly nor under CFC or similar rules). In order to avoid unintended economic double taxation, State B should take into account any indirect taxation of the income. For example, State A (or any other state) could tax a profit transfer from B to A Co (or another shareholder) as a dividend or, in the absence of such profit transfer, a capital gain upon later disposal of the shares in B. However, the difficulty is timing: if such economic double taxation is not certain from the outset (i.e. the whole "arrangement" only leads to a deferral rather than to a "true" deduction/non-inclusion effect), State B would have to monitor the facts and to retroactively eliminate taxation. If A Co is not a group company but just one of several investors in B, it seems to be unlikely that B's management and the tax administration of State B are in a position to know how the income is treated in the hands of the foreign investors.

Taxation of income in the hands of A Co is also contrary to the basic features of State B's tax system. There is not a sufficient link to tax foreign investors' profits which are not attributable to a domestic PE. Taxation of income in the hands of A Co by State B will generate even more difficulties than taxation of income in the hands of entity B. B's management and the tax administration of State B are unlikely to have sufficient knowledge of the potential non-inclusion of A Co's income by any other state. In addition, enforcing taxation against A Co may turn out to be difficult.

3.4.6. Result

Apart from the application of CFC rules (and GAAR, if appropriate), no specific anti-hybrid rules for any state involved seem to be advisable.

4. Conclusions

It should be clarified whether Action 2 of the BEPS Action Plan is focused on neutralizing the effects that are caused by hybrid entities or on more general mismatches. This clarification is of particular importance with regard to situations involving a group taxation regime.

If the scope of Action 2 is not limited to hybrid entities, such scope should be clearly defined. In particular, in deduction/non-inclusion cases, a policy decision has to be taken as to whether the non-inclusion must have been caused by a hybrid entity (or instrument) or whether any non-taxation (for example, no corporate tax, tax holiday) should trigger the countermeasure.

There are important conceptual and practical differences depending on whether Action 2 results in the recommendation of rules specifically addressing:

23. Please note that withholding tax, if any, is disregarded.
24. *See also* Russo, *supra* n. 5, at p. 111.

- hybrid mismatch arrangements; or
- DCL issues caused by group consolidation; or
- any non-taxation in other states.

In order to avoid over-taxation by the simultaneous application of countermeasures in more than one state, the priority of such measures needs to be determined ("tie-breaker"). It is primarily for the state which qualifies foreign entities differently from their home state to introduce anti-hybrid mismatch rules in order to avoid double deduction or deduction/non-inclusion results. There are no good policy reasons and justifications for the home state of the hybrid entity to deny the deduction of a business expense just because another state qualifies the entity differently.

Moreover, anti-hybrid rules in the home state of the entity are difficult to formulate and to administer.[25] They contravene the ability-to-pay principle and may hit minority shareholders. In abusive cases, the home state may apply a GAAR. If Action 2 is restricted to hybrid entities, there is no reason at all for the home state to introduce an anti-hybrid rule for a double deduction situation.

In either state, rules need to be drafted to determine double deduction or deduction/non-inclusion results on a multi-year basis. If double deduction or deduction/non-inclusion results are of a temporary nature, any countermeasure should only apply to the deferral effects.

Also, rules need to be drafted to determine double deduction or deduction/non-inclusion results by taking into account not only the direct taxation of the income against which the deduction is set off by the other state but also the indirect taxation of such income (dividends and/or capital gains).

Legislators should not underestimate the theoretical and the practical difficulties which arise if the application of domestic taxation is made dependent on the details of foreign tax laws. Moreover, legislators should strive for acceptance of tax rules by businesses and other stakeholders. Just like any other tax legislation, hybrid mismatch rules should not be unbalanced and create excessive administrative burdens.

25. *See also* Bärsch & Spengel, *supra* n. 5, at p. 527.