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Cross-Border Financing Using Hybrid Instruments

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Hybrid Instruments

"A hybrid mismatch arrangement… exploits the difference in the tax treatment of instruments… between two or more tax jurisdictions… where the mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement."

- OECD BEPS Report

Hybrid Instruments

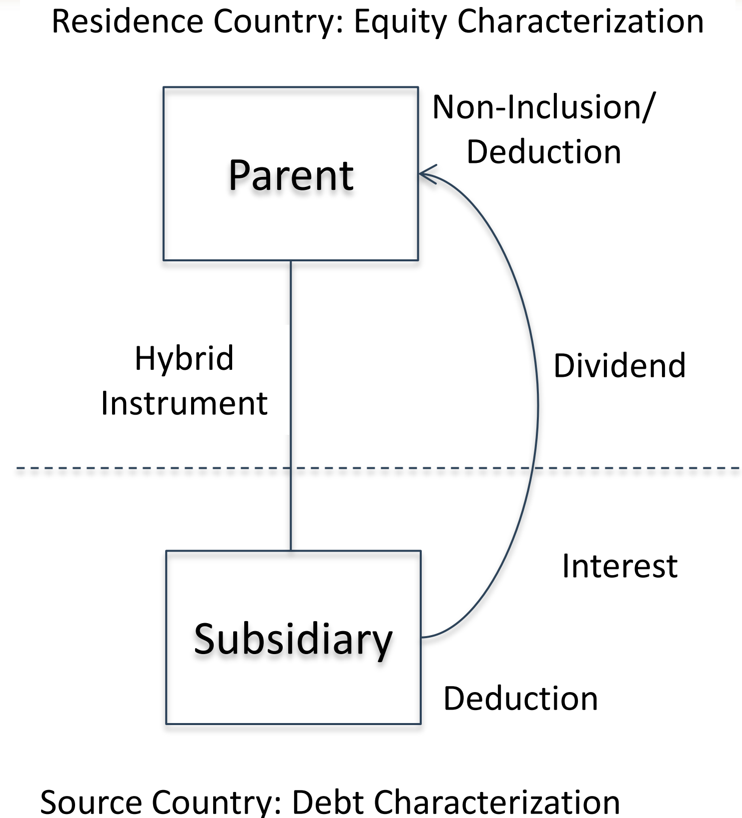
- Countries may characterize debt and equity differently for tax purposes
  - Some use legal form (e.g. “shares” = equity)
  - Others use economic substance or a factual analysis (e.g. preferred shares with certain characteristics may be considered debt)
- Tax planning using hybrid instruments may take advantage of different characterizations

Hybrid Instruments

- Source country considerations:
  - Most countries allow deductions for interest expenses, subject to rules such as thin capitalization, transfer pricing, etc.
  - Trend in many countries is to not impose withholding tax on interest payments
- Residence country considerations:
  - Most countries impose tax on interest income from foreign subsidiaries
  - But taxation of foreign-sourced dividends is often favourable through exemption systems

Hybrid Mismatch Arrangements

- Companies may produce tax arbitrage from differences in tax treatment by different countries
- Amounts deductible in Source Country may not be included in income in Residence Country

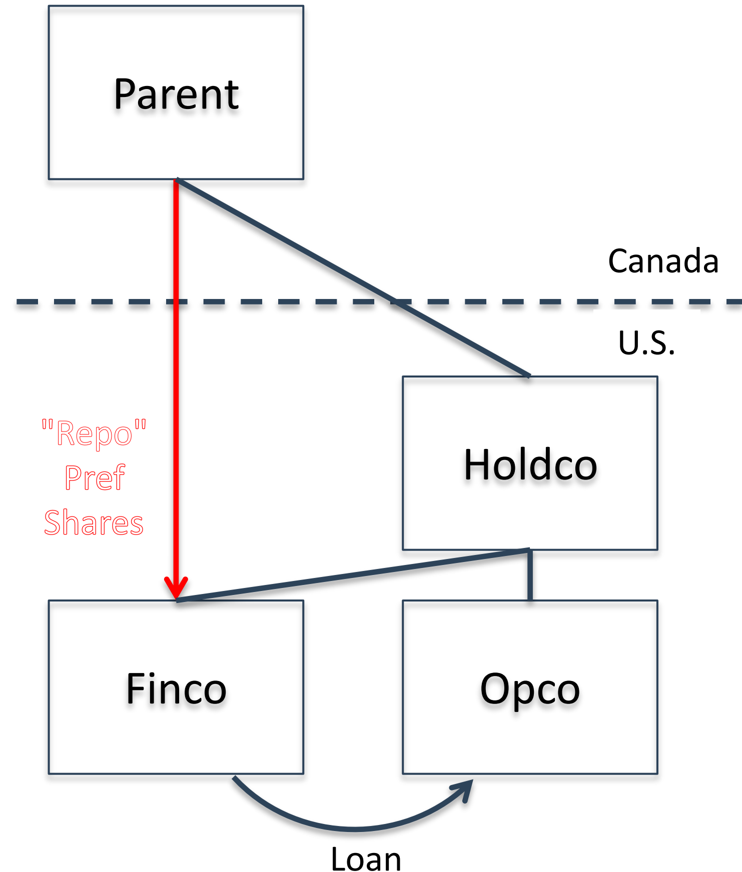


Canada – U.S. “Repo” Financing

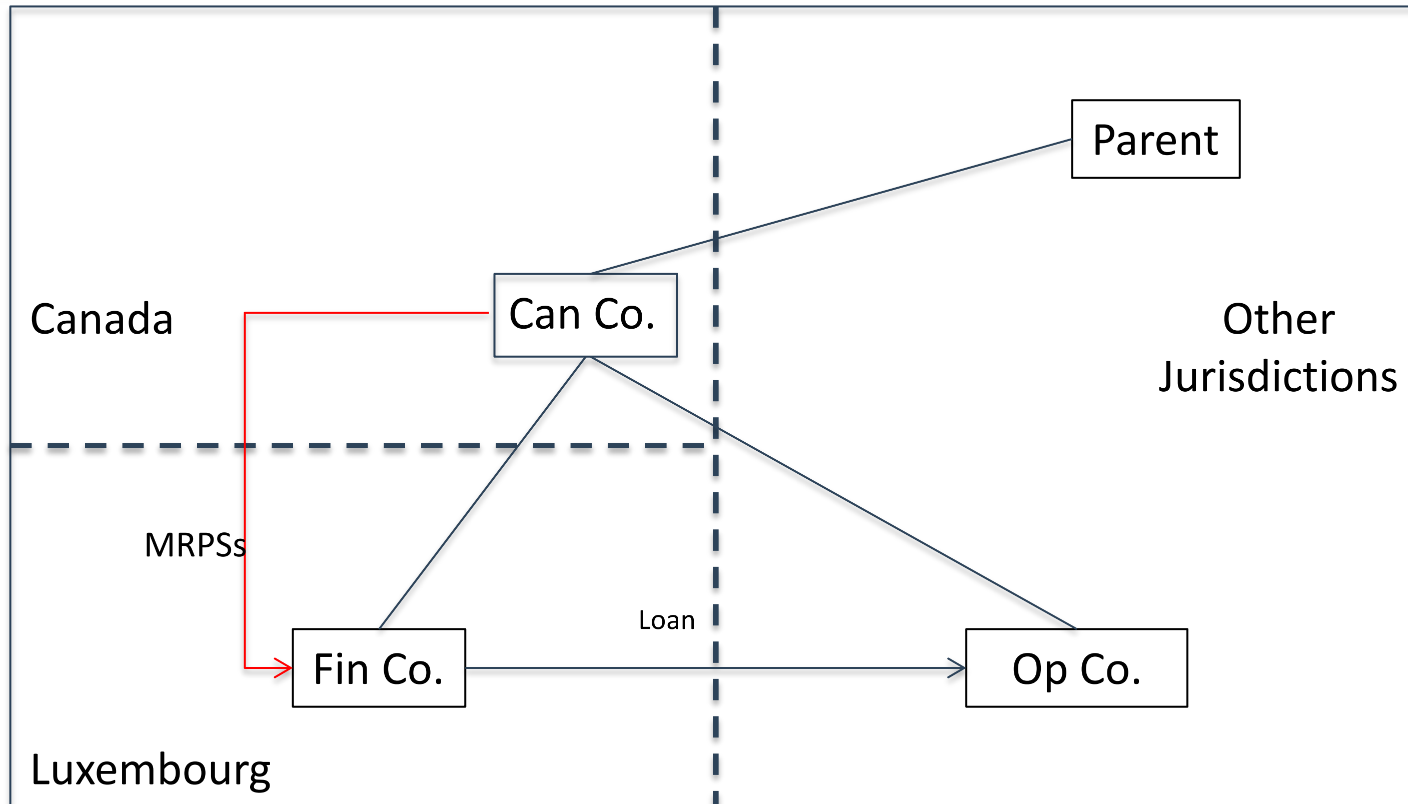
- U.S. may characterize preferred shares with certain attributes and structuring as debt
  - “Interest” deductions available in the U.S. on dividends paid to Canadian parent
  - Thin capitalization and various judicial doctrines must be considered
- Canada characterizes preferred shares as equity
  - If U.S. subsidiary earns active business income, dividends paid to Canadian parent subject to exemption system
- Result: deduction in U.S. and no income inclusion in Canada

Canada – U.S. "Repo" Financing

- "Repo" Preferred Shares sold to Parent
- Sale and Repurchase Agreement has fixed maturity date
- Fixed dividend rate
- Obligations subject to Guarantee Agreements
- Many "debt-like" characteristics



Canada-Luxembourg Mandatorily Redeemable Preferred Share Financing



See GGI Insider no. 66 (July, 2013)

Benefits of Hybrid Instrument Financing

Assumptions:

- Source country has no withholding tax on interest and of 5% withholding rate dividends
- Source country corporate tax rate of 35%; residence country corporate tax rate of 25%
- Dividend Income is exempt in Residence Country
- Interest Income is taxed in Residence Country
- Source Country has a Thin Capitalization Rule limiting D/E Ratio to 2:1
- All profits of the Subsidiary are repatriated

Benefits of Hybrid Instrument Financing

	Equity Financed	Debt Financed	Hybrid Financed
EBIT	$ 100.00	$ 100.00	$ 100.00
Interest Deduction	$ -	$ 41.88	$ 41.88
Taxable Income	$ 100.00	$ 58.13	$ 58.13
Source Country Tax (35%)	**$ 35.00**	**$ 20.34**	**$ 20.34**
Dividend to Parent	$ 65.00	$ 37.78	$ 37.78
Dividend Withholding Tax	$ 3.25	$ 1.89	$ 1.89
Received by Parent Co.	$ 61.75	$ 77.77	$ 77.77
Resident Country Tax (25%)	**$ -**	**$ 10.47**	**$ -**
Total Taxes Paid	**$ 38.25**	**$ 32.70**	**$ 22.23**
After-Tax Income	**$ 61.75**	**$ 67.30**	**$ 77.77**

BEPS Action Plan 2: Hybrid Mismatches

- OECD concerns over “double dip” (double deduction) or “deduction/non-inclusion”
- Double non-taxation
- But which country loses the tax – the source country or the residence country?
  - Depends on whether the base case comparison is debt or equity financing

Which Country Loses the Tax?

Revenue Loss on $100 of Financing

	Hybrid Versus Dividends	Hybrid Versus Interest
Tax Loss to Source Country	$ 16.02	$ -
Tax Loss to Residence Country	$ -	$ 10.47
Aggregate Tax Loss	**$ 16.02**	**$ 10.47**

- Tax loss to source country is only because of debt financing, not the hybrid instrument
- If the base case is equity financing, there is no tax loss to residence country

Assumptions: (1) Dividend income is exempt in the Resident Country; (2) Interest income is taxed in the Resident Country (3) Source country has a thin capitalization rule limiting the Debt to Equity ratio to 2:1 (4) Full repatriation of profits; (5) Corporate tax rate of 25% in Resident Country and 35% in Source Country.

Possible Government Responses

- Harmonized Domestic Laws
  - Doesn't seem possible
- General Anti-avoidance Rules (GAARs)
  - Effective but lack comprehensive response
  - Includes judicial nuances – "abuse of law," "economic substance," "business purpose," etc.
- Specific Anti-Avoidance Rules (SAARs)
  - Tax authorities are in catch-up mode

Possible Government Responses (cont'd)

- Transfer Price recharacterization?
  - Only effective if hybrid does not reflect arm's length terms
- Treaties
  - Amendments to Treaties possible, but take time
- Specific Anti-Hybrid Rule
  - Preferred approach in the BEPS report
  - Source country denies interest deduction on a hybrid instrument; "defensive" resident country rule that taxes the dividend

Examples of Government Responses

Canada:

- *Income Tax Act* s. 18.2 proposed to deny interest deductions to foreign affiliates (2007)
- Dept. of Finance scrapped the rule – never enacted

United States:

- Hybrid instruments a hot topic
- But, Repo Financing downgraded from reportable transaction to “monitoring status”

United Kingdom:

- Anti-hybrid rule in effect

Examples of Government Responses

Finland:

- Tax authorities attempted to apply transfer pricing rules and GAAR to a hybrid instrument in *Case KHO 2014:119*
- Court held that neither Article 9 of the Finland-Luxembourg treaty nor domestic transfer pricing laws could recharacterize the hybrid
- GAAR did not apply because there was no tax-avoidance motivation

Examples from other EU Countries…?

Elsewhere?

Conclusions

- Hybrid financing may increase the value of businesses significantly
  - Opportunities for hybrid instruments in various tiers of a corporate chain
- Harmonised international response very unlikely
  - Differing economic policy objectives – e.g. small open economies (Canada, Luxembourg) vs. larger economies (U.S., Germany)
- Bilateral Treaty responses possible, but take time
- Domestic responses possible, but not all countries are concerned

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