Correspondence of rules for tax treatment of hybrid financial instruments proposed by the OECD in pursuance of BEPS Action Plan (Action 2) to criteria of ‘good design’ offered in the discussion draft ‘Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’

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Abstract

This Master Thesis analyses measures introduced by the OECD and aimed at neutralizing the effect of implementation of hybrid financial instruments in tax planning. Namely, the measures offered in two public Discussion Drafts issued by the OECD in pursuance of Action 2 ‘Neutralise the effects of hybrid mismatch arrangements’ of the OECD BEPS Action Plan.

Introduction of new rules for taxation of hybrid financial instruments is a topic of high relevance nowadays. The OECD ranks completion of work on Action 2 prior to other issues of the BEPS Action Plan.

In March 2014, the OECD issued two discussion drafts which offered variants of new tax regulations for hybrid financial instruments in cross-border arrangements. The drafts were opened for public consultations and the responses were published in May 2014. Public responses show that the work on this issue is far from completion: measures proposed by the OECD are complicated and sometimes conflictive.

In this Master Thesis tax rules for hybrid financial instruments proposed by the OECD in the above mentioned discussion drafts are analyzed. The rules are assessed against criteria for ‘good design’ offered by the OECD in the Discussion Draft called ‘Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’. The Master Thesis undertakes to answer the question whether or not the proposed rules meet these criteria for ‘good design’.

Keywords: hybrid financial instruments; OECD; tax planning.
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List of Abbreviations

OECD - The Organisation for Economic Co-operation and Development (OECD)

BEPS Action Plan - Action Plan on Base Erosion and Profit Shifting;

OECD DL Draft - Discussion Draft ‘BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’;

OECD Treaty Draft - Discussion Draft ‘BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Treaty Issues)’;

OECD MC - OECD Model Tax Convention;

1. Introduction

1.1. Introduction to the theme of the Master Thesis

This Master Thesis offers a research on rules for tax treatment of hybrid financial instruments proposed in the discussion drafts published in pursuance of Action 2 of the OECD BEPS Action Plan, namely - the first Discussion Draft called ‘Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’\(^1\) and the second Discussion Draft called ‘Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)’.\(^2\)

Loss of budget tax revenues in the result of tax planning arrangements is a challenging topic nowadays. ‘Hardly a day passes without media headlines regarding the way in which large multinational enterprises manage their tax affairs.’\(^3\) Multinationals are at the prior concern as they have more resources and possibilities for structuring affairs in tax efficient manner compared to businesses situated within one jurisdiction. As it is pointed out by Happé, globalization has sufficient effect on tax planning and multinationals are under particular concern as they play crucial part in the process of globalization.\(^4\)

Businesses can utilize various technics for the purposes of tax planning. Happé names the following three:\(^5\) (1) exploitation of legal positivism theory, which allows ‘anything as long as a taxpayer complies with the letter of the law’; (2) benefits of tax heavens, when deductions are shifted to countries with high corporate tax rate while profits are allocated to low tax jurisdictions; (3) utilization of tax mismatches between jurisdictions, or tax arbitrage. A particular example of the last named technic can be found in utilization of hybrid financial instruments.\(^6\)

A lot of tax planning issues arise due to ‘disparities between unharmonized national corporate tax systems’.\(^7\) It is widely accepted that national actions are limited nowadays and effective measures against cross-border tax planning can be undertaken only in cooperation between governments. This explains why the problem of tax planning by multinationals should be addressed at the intergovernmental level.

Actions of the OECD as an organization which offers this level of cooperation can be a prominent example of a battle against tax planning. The OECD has issued a number of documents dedicated to this problem, to name the latest: ‘Action Plan on Base Erosion and Profit Shifting’\(^8\) and ‘Addressing Base Erosion and Profit Shifting - Report’.\(^9\) The OECD addresses a wide scope of issues and implementation of hybrid financial instruments is among them. Importance of elaboration of new measures against

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\(^1\) Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ (March 2014) International Organizations’ Documentation IBFD
\(^2\) Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)’ (March 2014) International Organizations’ Documentation IBFD
implementation of hybrid mismatch arrangements is confirmed by the fact that the OECD scheduled completion of work on this item of the OECD BEPS Action Plan on September 2014, which is earlier than dates for expected outcomes on other BEPS’s issues.\textsuperscript{10}

Utilization of hybrid financial instruments in tax planning is based on their inconsistent tax treatment in contracting jurisdictions. Hybrid financial instruments can be defined as ‘instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.’\textsuperscript{11} This can be crucial for tax treatment of hybrid financial instruments due to the fact that the majority of countries provide different tax treatment for debt and equity. This can result in double non-taxation of the payments under instrument: for example, if a certain instrument is treated as debt in a paying jurisdiction and as equity in another, payments under such instrument may escape taxation in both jurisdictions.

It is worth saying that dualistic characteristic of hybrid financial instruments can not only be beneficial for a taxpayer but can also entail double taxation. This can be the case if the same instrument is treated as equity in paying jurisdiction (thus, allowing no deduction of the payment from the taxable base) and as a debt instrument in the jurisdiction of the holder (which entails taxation of payments under this instrument in the latter jurisdiction). This issue is, however, out of scope of this Master Thesis, which focuses on measures against implementation of hybrid financial instruments in tax planning arrangements aimed at reduction of overall paid taxes.

\textbf{1.2. Motivation for the research}

As it follows from the above, tax treatment of hybrid financial instruments is a challenging topic currently. It is important that this issue should be addressed on the international level as it originates from mismatches in legal systems of contracting jurisdictions. At the international level the topic is addressed by the OECD. The OECD has identified hybrid financial instruments as one of the key pressure area in international taxation and elaborated relevant policy options for regulation of hybrid financial instruments. Thus, Action 2 of the OECD BEPS Action Plan calls for development of unified rules in order to neutralize the effect of hybrid mismatch arrangements (and hybrid financial instruments, in particular).

In March 2014 the OECD Committee on Fiscal Affairs has released two consultation documents on Action 2 of the OECD BEPS Action Plan. These are two Discussion Drafts called ‘Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’\textsuperscript{12} and ‘Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)’.\textsuperscript{13} These documents were open for public discussion and the responses were published in May, 2014.

\textsuperscript{11} Paragraph 10 of the Report ‘Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues’ (March 2012) International Organizations’ Documentation IBFD
\textsuperscript{12} Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ (March 2014) International Organizations’ Documentation IBFD
\textsuperscript{13} Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)’ (March 2014) International Organizations’ Documentation IBFD
That does not mean, however, that the work on this issue is close to an end. On the contrary, public responses indicated that draft measures should be a subject for further sufficient elaboration. In particular, the OECD DL Draft has offered a set of principles of ‘good design’. According to the OECD, only rules that correspond to these principles should be adopted and can be taken as a basis for regulation of mismatching outcomes in taxation of hybrid financial instruments. A wide public discussion of the OECD initiatives indicates that the research question of this Master Thesis is highly up-to-dated and this topic is of extreme applicability. This research question supposes analysis of the most recent documents and initiatives in this area.

1.3. Research question and method

The following research question will be answered in the Master Thesis:

*Do measures for tax treatment of hybrid financial instruments proposed by the OECD in pursuance of Action 2 of the BEPS Action Plan meet criteria for ‘good design’ offered in discussion draft ‘Neutralise the Effects of Hybrid Mismatch Arrangements – Recommendations for Domestic Laws’?*

The research question seems to be of sufficient academic and societal relevance as it addresses the most recent initiatives in tax regulation of hybrid financial instruments.

The OECD has issued two Discussion Drafts which address tax treatment of hybrid financial instruments in national law and in bilateral tax treaties. However, only the first Discussion Draft offers criteria for rules of ‘good design’. The second Discussion Draft (for treaty issues) does not offer comprehensive set of measures to regulate taxation of hybrid financial instruments, but rather refers to the provisions of the first Discussion Draft (for domestic measures). For the aim of comprehensive analysis of the new rules proposed by the OECD both drafts will be analyzed in this Master Thesis.

The OECD Discussion Draft ‘Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ offers a number of design principles for the purposes of composition of new tax rules for hybrid financial instruments. Thus, according to paragraph 27 of the above draft, rules can be treated as designed in a proper way if they are:

- applied automatically;
- comprehensive;
- coordinated;
- minimize the disruption to existing domestic law;
- clear and transparent in their operation;
- keep compliance costs to a minimum;
- easy for tax authorities to administer.

Detailed description of each of the above design principles is provided in paragraph 4.1. of the Master Thesis.
In order to answer the research question the measures proposed by the OECD should be assessed against above criteria of ‘good design’. The research method is limited to the assessment of general rules proposed by the OECD; rules that are proposed for taxpayers representing specific business area – such as financial and insurance organizations – are out of scope of this Master Thesis. Hybrid financial instruments may entail not only mismatches in tax treatment caused by a difference in the way instrument is characterized for tax purposes but also caused by difference in tax treatment of a particular payment made under the instrument. These arrangements are out of scope of this Master Thesis as it focuses on instruments which have different qualification in jurisdictions concerned.

The research question supposes interrelation with other law disciplines, namely, with civil law, because tax treatment of hybrid financial instruments often depends on civil law classification of these instruments as debt or as equity. Classification of hybrid financial instruments becomes a complicated issue in cross-border transactions as each jurisdiction has its own rules for debt and equity classification. Thus, taken into account the importance of civil law regulation of hybrid financial instruments this issue cannot be left aside when speaking about utilization of hybrid financial instruments in tax planning.

1.4. Outline of the Master Thesis

Due to the fact that a problem of classification of hybrid financial instruments is an underlying issue for their tax treatment it is addressed as a starting point of the research in chapter 2 of the Master Thesis. Approaches for classification of an instrument as debt or equity in tax law and in civil law are examined in subparagraph 2.1.1. of the Master Thesis. Importance of classification of an instrument as debt or equity is explained by the fact that these categories enjoy inconsistent tax treatment. Thus, it seems interesting to address the question of justification of this inconsistent treatment in this Master Thesis. This issue is examined in subparagraph 2.1.1. of the Mater Thesis. Practical examples of implementation of hybrid financial instruments in tax planning are described in paragraph 2.2. of the Master Thesis.

The third chapter of the Master Thesis is dedicated to the OECD initiatives for tax treatment of hybrid financial instruments. These initiatives are overviewed in paragraph 3.1. of the Master Thesis. Measures proposed for domestic legislation and for the bilateral tax treaties are studied in paragraph 3.2. and paragraph 3.3. of the Master Thesis, correspondently.

In chapter 4 the measures proposed in OECD discussion drafts are assessed against the design principles which should, in the opinion of the OECD, be taken as a criteria of good design.

In the final chapter the findings of the Master Thesis are brought to a conclusion.

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2. Classification of hybrid financial instruments as debt or equity

Mismatches in taxation of hybrid financial instruments in cross-border situations arise due to inconsistent treatment of one and the same instrument in contracting jurisdictions: an instrument can be treated as debt in one jurisdiction and as equity in another. Possibility for dualistic characteristic of hybrid financial instruments makes them an attractive mean for tax planning in cross-border situations.

In the following paragraphs I will address the issue of antipodal tax treatment of debt and equity and will assess the reasons for this inconsistent treatment.

2.1. Debt and equity. Grounds for different classification in contracting jurisdictions

2.1.1. Trade-off between debt and equity financing

As it was stated above, the starting point for trade-off between debt and equity financing is that interest expenses are deductible from the taxable income while dividends are, as a rule, not.

Although it is commonly accepted that taxes should be neutral to business decisions,\textsuperscript{15} and ‘tax legislation should not favor debt or equity financing’\textsuperscript{16} determination of capital structure seems to be strongly linked to tax considerations, based on this unequal tax treatment of debt and equity. At the same time it is well-known that lack of neutrality between debt and equity tax treatment\textsuperscript{17} can turn tax factors into prevailing arguments in decision-making process.\textsuperscript{18}

Confirmation for the above conclusion can be found with Hovakimian, Opler and Titman. They point out that business always takes into account a preferable tax treatment of debt when choosing optimal capital structure.\textsuperscript{19}

What can be an explanation for different tax treatment of debt and equity? The following reasons can be suggested.

(1) Price for limited liability of shareholders

This reason for distinction between debt and equity can be found at Emmerich.\textsuperscript{20} He supposes that shareholders’ liability is limited to the price of their shares. Otherwise shareholders would be personal liable for the company’s debts. However, creditors are also not personally liable for the debts of the company, but at the same time they are not owners of this company. In other words, shareholders benefit from investing through the corporate form, whereas creditors do not. Consequently, according to Emmerich, ‘it is legitimate to exempt from corporate taxation only distributions made to creditors.’\textsuperscript{21}


\textsuperscript{20} Adam O. Emmerich, ‘Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation’ (1985) University of Chicago Law Review, 1, page 122

\textsuperscript{21} Adam O. Emmerich, ‘Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation’ (1985) University of Chicago Law Review, 1, page 122
However, this argument can be criticized as it is based on the assumption that only creditors should benefit from the more preferable tax treatment of debt (compared to dividends) as they do not invest through corporate form. But deductibility of interest expenses can also be in favor of shareholders because it lowers taxable income and, consequently, increases company’s after tax income that can be distributed.

(2) Risk of shareholders and risk of creditors
The border between debt and equity can be drawn based on the character of risk undertaken by investors. Thus, following Flannigan, risks of equity investors are linked to the performance risk of the enterprise and can be described as:

- risks that the capital will appreciate or be wholly or partially lost as a result of the quality of performance. Lenders, on the contrary, keep the right to recover their original investment regardless of the economic performance of the borrower;
- equity contributors undertake the risk of unpredictability of returns. For the classical debt obligation the expected return is known in advance;
- equity contributors have ability to participate in control over the enterprise or, in other words, the power to participate in defining the risk associated with the undertaking. Debt providers do not possess such control.

(3) The nature of interest and dividend payment
It can be argued that interest expenses should be treated in the same manner as any other business expenses because debt is usually obtained in order to finance the business of a taxpayer. Consequently, interest expenses should be deductible. This point of view can be found in particular at Boltar. She underlines that dividend distributions, in their turn, ‘constitute distributions of earnings of capital and, as such, cannot constitute expenditure incurred in the production of income.’ The same reasoning for distinguishing debt and equity can be found in working paper of European Commission ‘The Debt-Equity Tax Bias: consequences and solutions.’

(4) Level of taxation of lender and shareholder
The other reason for allowing deduction of interest expenses can be found by systematic analysis of taxation at the level of the lender and at the level of debtor: taxation of interest income at the

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level of the lender without permission to deduct these expenses from the taxable income of the borrower will lead to economic double taxation which can be burdensome for business.

(5) Socioeconomic objectives
There is also one rationale behind denial of deduction for dividend expenses from a taxable income of the paying company. That is an assumption that ‘allowance of such a deduction would be too costly to the revenue.’ The counter-evidence for this argument can be found in the following: this point of view can be hardly accepted as it may lead to a suggestion that any expense can be disallowed in order to increase the budget revenue. Example of Belgium where notional interest deduction is allowed can be representative in this respect. 29

Based on the above, it can be concluded that there is no singular explanation regarding the reasons for incompatible tax treatment of debt and equity. However, tax rules of majority jurisdictions distinguish between debt and equity and foster business to decrease reported profit via debt-shifting or via utilization of hybrid instruments. 30

As it is underlined in the first public Discussion Draft ‘Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ hybrid financial instruments rely on differences in the way jurisdictions characterize payments under the instrument. 32 Thus, in the frames of this Master Thesis it is necessary to study approaches implemented in different jurisdictions for debt / equity classification. This analysis will give a comprehensive understanding of the problem.

2.1.2. Approaches for debt/equity classification implemented in different jurisdictions
The concepts of debt and equity, as it is stated by Schön, have been created in context of civil law, in particular, contract law, corporate law and insolvency law and, thus, guiding principles for classification of hybrid financial instruments for tax reasons can often be found there. Each jurisdiction has its own rules, however, some common features can be found in the prevailing number of jurisdictions.

To give an example, the paper titled ‘Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis’ 33 can be addressed. This paper analyzes rules for debt / equity classification of the following countries: Brazil, Germany, France, Greece, the Netherlands, Austria, Switzerland, the UK and the US. The undertaken analysis shows that debt and equity are usually distinguished in civil law as described in subparagraph 2.1.2.1. of the Master Thesis.

31 Discussion Draft ‘BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’(March 2014) International Organizations’ Documentation IBFD
2.1.2.1. Civil law classification

Speaking about the equity, it should be noted that the rights of partners/shareholders are based on a partnership agreement or a company statute. These rights are ‘bundled together under the concept of equity’.  

Partners/shareholders usually have the following rights:
- control of the assets and the operation of the enterprise;
- participation in profits and losses of the business;
- in a case of insolvency the claims of shareholders/partners are satisfied after claims of creditors.

Contrary to shareholders and partners which are connected to the enterprise via a partnership agreement or a company statute, creditors are banded to the company via loan agreement. The scope of rights of a creditor as a contrast to rights of shareholder can be viewed on example of a fixed interest loan:
- a creditor has no control over enterprise (no voting, management or other control rights);
- the right of the creditor for repayment is fixed;
- claims of the creditor have priority over claims of shareholders.

The above general rights of equity and debt holders, based on which distinction between debt and equity can be made, can be found in nearly all legal systems. At the same time, a lot of legal systems provide a possibility for modifying the debt/equity rights which can result in hybridization of financial instruments. In the paper ‘Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis’ the following aspects as regards deviation from a classical debt/equity model are identified:
- the period of existence of the right for repayment is no longer the determinative factor in distinguishing between debt and equity. Thus, shares can be issued with an ability to terminate; on the contrary, obligations under loan agreement can set forth a permanent postponement of repayment;
- participation rights: voting rights of the shareholders can be removed in all jurisdictions examined in the paper of Schön. For example, in the UK not only preference shares, but also ordinary shares can be issued without voting rights; at the same time, some participation rights can be granted to creditor, as, for example, in France, where laws grant

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participation rights and the right to be heard at the general meeting of a Société Anonyme to representatives of debenture holders;\footnote{Wolfgang Schön and other, ‘Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis’ (2014) British Tax Review, No 2, page 157} as a general rule the claims of creditors rank prior to claims of shareholders in case of insolvency. That may differ, for example, in case of shareholder loans: they are given a lower ranking than the remaining debt; however shareholder loans, due to their character as debt, must be satisfied before actual equity instruments.\footnote{Wolfgang Schön and other, ‘Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis’ (2014) British Tax Review, No 2, page 161} Example can also be found in rules of Germany and Austria which provide that obligations under participation certificates can be ranked behind all other creditors; however, this subordination can be limited to the repayment of the capital and therefore does not extend to the arrears of interest.\footnote{Wolfgang Schön and other, ‘Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis’ (2014) British Tax Review, No 2, page 161}

As it follows from the above, civil law has formed a number of criteria for the purposes of characterization of financial instruments as debt or equity. As it is underlined by Schön, ‘civil law plays a major role when it comes to the characterization of a financial instrument as debt or equity in the context of income taxation’.\footnote{Wolfgang Schön and other, ‘Debt and Equity in Domestic and International Tax Law - A Comparative Policy Analysis’ (2014) British Tax Review, No 2, page 161} However, approaches implemented in different jurisdictions may vary. They are studied in the following subparagraph.

### 2.1.2.2. Classification for tax reasons

The International Fiscal Association states in its branch Report ‘Tax treatment of Hybrid Financial Instruments in Cross-Border Transactions’ (published in 2000), that a surprising number of jurisdictions simply rely on the legal form or commercial, accounting or regulatory treatment to establish the treatment for tax purposes.\footnote{Patricia Brown, ‘The Debt-Equity Conundrum’ (2012) Cahiers de Droit Fiscal International, 97b, page 22} However, each jurisdiction has its own number of rules. The following approaches for classification of financial instruments for needs of taxation are possible:

1. Classification based on the form of the instrument. That means that a name of the instrument is taken as a main determining factor. This approach can also be addressed as ‘form over substance’. It can be viewed on the example of Belgium which grants a dominancy of the Civil Code definition for the purposes of tax treatment. There is no legal basis for reclassification of the contract or legal relationship if they were correctly and rightfully classified following the principles within the Belgian Civil Code.\footnote{Stijn Vanoppen, ‘Branch Report: Belgium’ in ‘The Debt-Equity Conundrum’ (2012) Cahiers de Droit Fiscal International, 97b, page 113} In the opinion of Wiedermann-Ondrej, this approach, where form dominates over substance, can lead to tax arbitrage and tax avoidance and to ‘differentiating results for economically
identical instruments." It can be taken as an explanation for the fact that the prevailing number of jurisdictions are now following the ‘substance over form’ approach.

(2) ‘Substance over form’ doctrine assumes that the analysis of the instrument should be based on its economic characteristics. Countries implement the ‘substance over form’ doctrine in several ways. The first one can be found in the USA where the instrument should be qualified (and, consequently, should be taxed) according to its predominant debt or equity feature. Here, an instrument should be tested against a number of qualifying characteristics and should be assigned to the debt or equity group depending on prevailing group characteristics. Other countries have just one or two determinative factors which decide the legal faith of the instrument. If the instrument contains the required feature it should be qualified either as debt or equity. This approach, contrary to the one implemented in the USA, provides businesses and tax authorities with more legal certainty, thus, minimizing the risk that an instrument will be re-classified by tax authority or by the court.

(3) Another classification method, also known as ‘bifurcation’, assumes that the instrument should be divided into debt and equity parts. Consequently, taxation will be made following the qualification of each part. As Wiedermann-Ondrej underlines ‘this seems a logical consequence if an instrument has components such as conversion rights, options or futures. […] Unfortunately, in practice, this method raises as many questions as the facts and circumstances method because there are endless ways to structure an instrument with different rights and obligations and therefore bifurcation can lead to different results with economically the same instruments.’ I should agree with the point of view of Wiedermann-Ondrej as this kind of analysis can be rather complicated. That means that business cannot be provided with single and clear solution which increases the possibility for disputes.

(4) The next approach in drawing the line between debt and equity is to address to financial accounting rules. Although this approach is not widely implemented, it is accepted by a big and influential jurisdiction such as Germany where tax accounting rules should be based on commercial accounting. However, Germany has made an exception for some cases: hybrid financial instruments can be reclassified as equity if both remuneration payments participate in

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53 Peter Essers and others 'The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts' (2009), page 33
the current profits of the capital borrower and the capital repayment participates in the liquidation proceeds of the capital borrower. 54 Interesting that German rules allow reclassification of interest-generating debt into dividend-generating equity, but do not allow reclassification in the reverse case. 55

As we see from the above, classification of debt and equity for tax reasons lies in the area of national law. It can be rules of national civil law or accounting rules. However, some jurisdictions employ a debt / equity tax concept that varies from the concept offered by civil law or even offered by accounting rules and is implemented solely for tax purposes. 56 Sometimes practice of tax authorities increases the distance between tax definition of debt / equity from that of the civil law due to the attempt to reclassify instruments based on the ‘economic substance’ or general anti-abuse rules. 57

Classification of debt and equity might not become a problem within a single jurisdiction as all parties concerned will be guided by the same rules. However, the problem arises in the light of cross-border transactions: incompatible classification of debt and equity by contracting jurisdictions entails that one and the same financial instrument can be qualified as a debt instrument in one state and as an equity instrument in another state. Such instruments are addressed as ‘hybrid instruments’. In the following paragraph I will describe some examples of implementation of hybrid financial instruments into tax planning arrangements.

2.2. Examples of implementation of hybrid financial instruments in cross-border business arrangements

As it follows from the analysis undertaken in previous paragraphs, an entity paying the remuneration under a hybrid financial instrument is interested to qualify the instrument as debt which means a possibility for tax base reduction. From the point of view of the entity receiving the payment, it is, on the contrary, more beneficial to qualify the instrument as equity if dividends are taxed in more beneficial way or even exempted under participation exemption.

The starting point for the analysis of practical utilization of hybrid financial instruments can be found in one of the basic documents as regards to the problem of implementation of hybrids in tax planning, namely – in the OECD report ‘Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues’. 58 This example refers to situations described in paragraph 16 of the OECD HMA Report as ‘deduction / no inclusion schemes’, i.e. arrangements where a deduction related to the same contractual obligation is claimed for income tax purposes in two different countries. This example is represented in Figure 1 an explained further.

54 Sven-Eric Bärsch, Christoph Spengel, ‘Hybrid Mismatch Arrangements: OECD Recommendations and German Practice’ (2013) Bulletin for international Taxation, 10, page 522
55 Sven-Eric Bärsch, Christoph Spengel, ‘Hybrid Mismatch Arrangements: OECD Recommendations and German Practice’ (2013) Bulletin for international Taxation, 10, page 522
(a) Example 1.

*Figure 1.*

The example given in the OECD HMA Report refers to two entities established in different jurisdictions. One of the entities is financed with an instrument which is treated as equity in the financing jurisdiction and as debt in the jurisdiction of the recipient. As a logical consequence the payment is deductible for tax purposes in the second jurisdiction and at the same time is treated as exempted dividends in the first jurisdiction. The result is ‘a net deduction in one country without a corresponding income inclusion in another one.’

The above example of the OECD HMA Report is a simple one. We can assume that more difficult arrangements are usually implemented in practice. For example, as it is shown in a case of the Dutch Supreme Court, No. 12/03540, BNB 2014/79.

(b) Example 2: *The case of the Dutch Supreme Court, No. 12/03540, BNB 2014/79*

*Figure 2.*

This case is interesting as it demonstrates that tax treatment of hybrid financial instruments has been in the spotlight in the Netherlands currently. It is an up-to-date case as the decision of the Dutch Supreme Court was announced on 7 February 2014. Further I will not focus on Dutch law rules in details but will briefly describe the circumstances of the case and will pay attention to the financial arrangements that were utilized by the parties.

Before describing the nature of financial arrangements of this case it is necessary to note that under the Dutch tax law interest expenses are generally deductible whereas profit distribution is not (plus dividend withholding tax is levied). In principle, qualification of a financial instrument as debt or equity for reasons of taxation is dependent on its qualification for civil law purposes. However, debt for civil law purposes can be treated as equity for tax purposes in the following cases: sham loans (in Dutch called ‘schijnleningen’), loss financing loans (in Dutch called ‘bodemlozeputleningen’) and participating loans (in Dutch called ‘deelnemerschapstleningen’). To characterize debt as a participating loan, the following conditions developed under Dutch case law must all be met:

- the remuneration on the loan is dependent on the profit of the borrower;
- the loan is subordinated to the claims of all other creditors; and
- the loan has no term or is perpetual (a loan having a term in excess of 50 years is considered to have met this condition).

In the case concerned a Dutch corporate taxpayer granted shareholder loans to its Australian subsidiary. After restructuring the shareholder loans were converted into redeemable preference shares with the following characteristics: ‘(i) annually paid cumulative preferred dividend of 8 %, increasing to 12 % of the amount contributed on the redeemable preference shares, (ii) shares had basically no voting rights and (iii) shares would be redeemed within ten years.’

Tax consequences of the restructuring were that the Dutch company was not any longer taxed on interests from the shareholder loan and income from the redeemable preference shares was not taxed due to the participation exemption. Dutch tax authorities claimed the payment to be taxed as interests because, in the opinion of tax authority, the conversion was artificial and was made with the purpose to avoid taxation in the Netherlands.

The Dutch Supreme Court ruled that classification of a finance instrument by the civil law is decisive. If a shareholding exists for Dutch civil law the participation exemption should apply. The fact that the remuneration on the redeemable preference shares is deductible in Australia and that the redeemable preference shares have the characteristics of a debt instrument, should not have any adverse consequence on the application of the Dutch participation exemption.

Thus, the above case, on the one hand, shows, how arrangements can be implemented by business in practice and, on the other hand, explains one of the approaches described in paragraph 2.2. of the Master Thesis as regards to qualification of hybrid financial instruments for tax reasons. The case refers to Dutch practice. However hybrid financial instruments are utilized worldwide. To demonstrate it I will

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60 BNB 1957/239  
61 BNB 1998/208  
62 BNB 2006/82  
63 Hoge Raad No. 12/03540, BNB 2014/79, LC Haarlem (Rechtbank Haarlem), 25.01.2011, 09/3391, VN 2011/32.12; AC Amsterdam (Gerechtshof Amsterdam), 07.06.2012, 11/00174, VN 2012/40.11  
64 Gabriel van Gelder, Boudewijn Niels, ‘Tax Treatment of Hybrid Finance Instrument (July/August 2013) Derivatives & Financial Instruments, page 142  
65 Hoge Raad Dutch Supreme Court 07.02.2014, No. 12/03540
further address to another jurisdictions, namely the USA. It is interesting, that the following case implements arrangements within Dutch jurisdiction as well.

(c) Example 3: PepsiCo case

PepsiCo case (PepsiCo Puerto Rico Inc., et al. v. Commissioner, T.C. Memo. 2012-269)\(^6\) refers to utilization of the so-called ‘advance agreements’ (i.e. intercompany advances). The question put before the court was whether advance agreements should be characterized as equity or debt. The structure of the PepsiCo Group is represented at Figure 3.

Figure 3.

Notes to Figure 4:

Adv. – Advanced Agreement
PWI - PepsiCo Worldwide Investments (the Netherlands)
PGI - PepsiCo Global Investments (the Netherlands)

As this subparagraph is aimed at providing examples of practical implementation of hybrid financial instruments I will not focus further on issues of this case except for closely connected with financial instruments that were utilized.

In this case, PepsiCo Global Investments (‘PGI’), a Dutch entity, issued to PepsiCo Puerto Rico - a company belonging to PepsiCo group and established under laws of Delaware - advance agreements in

\(^{66}\) Published at the web-site of the United Sates Tax Court
http://www.ustaxcourt.gov/InOpHistoric/pepsicomemo.TCM.WPD.pdf
exchange for notes of companies belonging to PepsiCo group. As it is stated in the Court’s decision, PepsiCo sought to create instruments (the advance agreements) which would be classified, as debt in the Netherlands and treated as equity in the United States.

Advanced agreements were structured as follows. They provided for payments of principal amounts after initial terms of 40 years, with PGI having unrestricted options to renew the advanced agreements for a period of 10 years. In case a related party defaulted on loan receivables the advanced agreement would become perpetual.

The advanced agreements stipulated that a preferred return - consisting of a base preferred return and a premium preferred return which should be accrued semiannually and unconditionally on any unpaid principal amount. Amounts of unpaid preferred return were to be capitalized. Capitalized base preferred return was to be made annually. It was stipulated that unpaid principal return, accrued but unpaid preferred return, any unpaid capitalized base preferred return and any unpaid capitalized premium preferred return could be paid in fully or partly by PGI at any time. The obligation to pay any of the above amounts was subordinated to all the indebtedness of PGI. The rights of all PGI creditors to receive payments were ‘superior and prior to’ the rights of the holders of the advanced agreements. The advanced agreements provided the holders the right to declare unpaid principal and preferred return immediately due and payable upon dissolution, insolvency, or receivership of PGI, but such rights were subject to the ‘net cash flow’ restrictions and remained subordinated to all indebtedness of PGI and the rights of all creditors.

Nearly all of the amounts received by PGI under the US related party notes were paid out to the holders of the advanced agreements, with each preferred return payment being made on the same date that interest due on the US related party notes was paid to PGI.

The US court decided that instrument more closely resembled equity. When solving the issue the court applied a debt-vs-equity analysis based on the factors developed in its case law which I won’t focus on in this Master Thesis as these factors could be relevant only in respect to US law practice. However, it should be noted that the court paid attention to the fact that the advanced agreements contained equity-like terms such as subordination of payments to all other debt; restriction on use of net cash flows received from related party to make payments; long (perpetual) terms.

The above cases give some illustrative examples of utilization of hybrid financial instruments. The USA case is interesting as it involves rather complicated arrangements, however, clearly represents the basis for implementation of hybrid financial instruments into tax planning: parties provide these instruments with features that entail different classification for the purposes of each jurisdiction. The Dutch case attracts attention as it was decided by the Supreme Court recently, just some months ago, and, thus, confirms that the question of implementation of hybrid financial arrangements is an issue of a particular interest currently.
Utilization of hybrid mismatch arrangements (i.e. hybrid financial instruments as well) gives rise to a number of important policy issues, the most obvious being the loss of tax revenue,\note{Raffaele Russo, ‘The OECD Report on Hybrid Mismatch Arrangements’ (2013) Bulletin for International Taxation, 2, p. 111} as it is stated in the OECD Report ‘Hybrid Mismatch Arrangements: Policy and Compliance Issues’.\note{‘Hybrid mismatch Arrangements: Tax policy and compliance issues – Report’ (March 2012). International Organizations’ Documentation IBFD}

This explains the intent of governments to come to unified regulations of taxation of hybrid mismatch arrangements (and hybrid financial instruments, in particular) at the international level. One of the most prominent initiatives in this area is an extensive work of the OECD. In the following chapter I will examine the measures proposed by the OECD in order to mitigate the problem of utilization of hybrid financial instruments in tax planning.
3. Initiatives of the OECD against utilization of hybrid financial instruments

Tax treatment of hybrid mismatch arrangements, as such, and hybrid financial instruments, in particular, is one of the central issues with the OECD lately. In the following paragraph I will address the initiatives for tax regulation of hybrid financial instruments. Two discussion drafts for domestic and tax treaty regulations of hybrid financial instruments proposed by the OECD will be analyzed in the paragraph 3.2. and the paragraph 3.3. of the Master Thesis, correspondingly.

3.1. Overview of the OECD initiatives

It is accepted nowadays that the problem of tax structuring cannot be solved solely by means of pure domestic measures. This problem requires coordinated measures at the intergovernmental level. As underlined by Essers ‘unilateral solutions are no longer sufficient.’

Initiatives of the OECD are one of the most prominent examples of international cooperation in the tax area. The OECD addresses a wide range of issues, among which regulation of hybrid financial instruments. It can be assumed that measures against utilization of hybrid mismatch arrangements are treated by the OECD as one of the most important topics, because completion of work on this issue is scheduled by the BEPS Action Plan on September, 2014, and, thus, dates earlier than expected outcomes on other BEPS Action Plan’s issues.

The OECD has started its work for new regulation standards for hybrid financial instruments several years ago. In 2011 the OECD issued a report titled ‘Corporate Loss Utilisation through Aggressive Tax Planning’ which named financial instruments as one of the risk areas. Attention to hybrid financial instruments was attracted due to their ability to create artificial losses or ‘double-dip’ situations.

Concerned by the growth of sophistication in cross-border arrangements the OECD published a report titled ‘Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues’. This report was issued in March 2012 and opened a series of papers dedicated to tax planning by means of hybrid mismatch arrangements. The Report deals with utilization of hybrid instruments, hybrid entities and transfers between two or more countries. According to this report, the negative effect of hybrid mismatch arrangements for state tax revenue can be reduced by eliminating differences in tax treatment of entities, instruments and transfers.

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69 Peter Essers, ‘International Tax Justice between Machiavelli and Habermas’ (February 2014) Bulletin for International Taxation, page 57
The OECD proceeded with its work on hybrid mismatch arrangements in the report ‘Addressing Base Erosion and Profit Shifting’.\textsuperscript{75} The OECD’s website indicates that the Base Erosion and Profit Shifting project ‘is looking at whether, and if so why, MNEs taxable profits are being allocated to locations different from those where the actual business activity takes place.’\textsuperscript{76}

The most recent OECD documents which are interesting in view of tax treatment of hybrid financial instruments are the BEPS Action Plan (published in July, 2013) and two Discussion Drafts for domestic and international tax rules which were proposed in order to solve the problem of mismatching tax outcomes arising in the result of implementation of hybrid financial arrangements.

The BEPS Action Plan points out that inconsistent tax policy of different countries may result in a reduction of the overall tax paid by all parties involved, which harms competition, economic efficiency, transparency and fairness. Measures undertaken by governments to protect their tax base may end up in double taxation or legal uncertainty for business if there is little coordination among them. Thus, the Action Plan concludes, that ‘fundamental, consensus-based changes are needed to address double non-taxation and cases of no or low taxation’.\textsuperscript{77} The OECD underlines that only coordinated intergovernmental measures can address the problem of hybrid mismatch arrangements. According to Action 2 of the BEPS Action Plan this should include two types of measures: alteration of domestic rules and adoption of new treaty rules. Based on this two-level strategy the Committee on Fiscal Affairs has released in March 2014 two consultation documents on Action 2:

- the first Public Discussion Draft ‘BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’;\textsuperscript{78}
- the second Public Discussion Draft ‘BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Treaty Issues)’.\textsuperscript{79}

The above drafts were opened for consultations; results of public discussion were published\textsuperscript{80} at the web-site of the OECD on May, 7, 2014.

In the following paragraph 3.2. I will examine measures proposed by the OECD DL Draft. Measures for tax treaties will be discussed in the paragraph 3.3. of the Master Thesis.

\textsuperscript{75} ‘Addressing Base Erosion and Profit Shifting – Report’ (2013) International Organizations' Documentation IBFD
\textsuperscript{76} http://www.oecd.org/ctp/beps.htm
\textsuperscript{78} Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ (2014) International Organizations’ Documentation IBFD
\textsuperscript{79} Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues) International Organizations’ Documentation IBFD
\textsuperscript{80} http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf
3.2. Measures addressing hybrid finance instruments in the Discussion Draft for Domestic Law

Double non-taxation caused by utilization of hybrid financial instruments arises due to inconsistence of domestic tax systems of contracting jurisdictions. It explains why the solutions for tax treatment of cross-border hybrid financial instruments can be found in the Discussion Draft ‘BEPS Action 2: Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’.

In the following subparagraphs I will describe measures proposed by the OECD for domestic law, namely, the scope of the rules (subparagraph 3.2.1.), a ‘primary’ and a ‘secondary’ rule (subparagraph 3.2.2.), a ‘top-down’ and a ‘bottom-up’ approach (subparagraph 3.2.3). The following subparagraphs have a descriptive character. Analysis of the OECD DL Draft will be made in Chapter 4 of this Master Thesis.

3.2.1. The scope of the rules

The OECD DL Draft has rather ambitious aims – it seeks to offer measures that can be implemented by all countries. This results in complexity of the rules which can be discovered starting from the definition of hybrid financial instruments proposed by the OECD DL Draft as it is based on two descriptive categories: ‘ordinary income’ and ‘deductible payment’. Hybrid financial instruments are defined as ‘financial instruments that result in taxpayers taking mutually incompatible positions in relation to the character of the same payment made under the instrument’.\(^{81}\) It is an instrument where ‘a payment made under the arrangement is deductible in the payer’s jurisdiction but not included by the recipient as ordinary income when the recipient calculates its net income for tax purposes’.\(^{82}\) It should be noted that proposed measure address instruments that are hybrids for tax purposes and do not deal with instruments that may entail hybrid effect solely for regulatory or accounting purposes.\(^{83}\) The OECD DL Draft targets the difference between the proportion of payments that are deductible by the issuer and the proportion included by the holder as ordinary income.\(^{84}\)

As it is stated above, the definition of hybrid financial instruments offered in OECD DL Draft is based on two terms: ‘ordinary income’ and ‘deductible payment’. In frames of this Master Thesis it is important to analyze the proposed definition, as it, in fact, identifies the scope of the prospective rules.

The following issues should be noted:

- the wording of definition;
- utilization of the term ‘ordinary income’;
- utilization of the term ‘deductible payment’.


\(^{84}\) Paragraph 87 of the Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ (2014) International Organizations’ Documentation IBFD
(a) Definition of hybrid financial instruments

Hybrid financial instruments have a very broad description. This entails applicability of draft rules to any instrument which is treated as debt or as equity under rules of jurisdiction applying the rule. It is worth saying that the OECD DL Draft leaves it up to the domestic law of each jurisdiction to define the list of hybrid financial instruments to which the new rules will be applicable. These lists should be formulated as wide as possible ‘so as to capture any financial instrument where a payment made under the arrangement is deductible in the payer’s jurisdiction but not included by the recipient as ordinary income when the recipient calculates its net income for tax purposes.’\textsuperscript{85} This open-ended formula may force countries to adopt lists that will be similarly open-ended. This also may end up in inconsistent definitions from jurisdiction to jurisdiction.

(b) ‘Ordinary income’

The OECD DL Draft utilizes the term ‘ordinary income’ for the purposes of defining the hybrid financial instruments. Ordinary income is explained as ‘income that is subject to tax at the taxpayer’s full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as credits for underlying tax paid by the issuer)’.\textsuperscript{86} The OECD DL Draft provides no further explanations as regards to ‘ordinary income’.

(c) ‘Deductible payment’

Based on the provisions of paragraph 93 of the OECD DL Draft it can be stated that under ‘deduction’ the draft means any payment that is not taxable in the relevant jurisdiction. In other words, it does not literally mean the deduction from a taxable income but it should be understood as any payment on which no tax is accrued. The OECD DL Draft equals deductions and other economically equal arrangements such as tax reliefs.

The draft leaves open the question whether the deduction should be utilized in reality or whether the draft addresses any ‘theoretical’ possibility to deduct expenses. Also the draft does not clear up the question about the evidences that can prove that the payment was either non-deducted in the payers state, or was included into the ordinary income of the recipient. In this respect it seems necessary for the draft to provide more detailed rules.

As it is seen from the above, correspondence of the OECD DL Draft in part of definition of the hybrid financial instrument to the principles of ‘good design’ can be put under question. Whether these


\textsuperscript{86} Paragraph 83 (b) of the Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ (2014) International Organizations’ Documentation IBFD
rules meet criteria for ‘good design’ will be assessed in Chapter 4. In the following subparagraph I will examine rules proposed by the OECD DL Draft for regulation of taxation of hybrid financial instruments.

3.2.2. Rules recommended by the Discussion Draft for Domestic Law

The OECD DL Draft proposes two rules that should solve the problem of mismatching tax treatment of hybrid financial instruments. These rules are addressed as ‘linking’ rules because they suppose interrelation of two measures which either prohibit deduction of expenses linked to hybrid financial instrument or prescribe inclusion of income derived from such instrument into taxable income. These rules are supposed to align tax outcomes for the payer and payee.\(^\text{87}\)

It can be concluded that the OECD DL Draft sets hierarchy of the proposed linking rules and marks them as ‘primary’ and ‘secondary’ rules. The ‘primary’ rule should apply whenever a hybrid mismatch arises, and the ‘secondary’, or ‘defensive’ rule, should be in effect only in circumstances where the primary rule was not applicable in the jurisdiction of the counterparty.\(^\text{88}\)

The rules are defined as follows:\(^\text{89}\)

1. The ‘primary’ rule: jurisdiction of the payer should deny a deduction for any payment made using a hybrid financial instrument, to the extent that the payee/investor does not include the receipt as ordinary income under the laws of any jurisdiction.

2. The ‘secondary’ (or ‘defensive’) rule: jurisdictions should require a payee/investor to include any payment under a hybrid financial instrument as ordinary income to the extent the payer is entitled to claim a deduction for such a payment or equivalent tax relief and the payer’s jurisdiction does not apply a hybrid mismatch rule.

3. Special rule for a dividend exemption system: a dividend exemption should not be granted under domestic law to the extent it is a deductible payment.

Although the OECD DL Draft sets forth the hierarchy between the above rules addressing them as the ‘primary’ and the ‘secondary’ rule, the draft contains no recommendations as to whether it is a payee or payer who has to determine the applicable rule. For example, paragraph 81 (a) of the OECD DL Draft suggests that if the payee does not include the payment as ordinary income then a deduction should be denied for the payer. In other words, the treatment for the payer is determined by the application of the rule by the payee. However, under provisions of paragraph 108 (b) it may seem that the payer is required to apply the primary rule.

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3.2.3. ‘Top-down’ and ‘bottom-up’ approaches

3.2.3.1. General description

The OECD DL Draft offers two approaches to define the scope of hybrid financial instruments to which the draft rules will be applicable: a ‘bottom-up’ approach and a ‘top-down’ approach. These approaches appear to demonstrate different attitude to the problem of hybrid financial instruments. The OECD DL Draft underlines that the ‘bottom-up’ approach targets the situations where parties consciously entered into hybrid arrangements.\(^{90}\) The ‘top-down’ approach, on the contrary, puts all hybrid instruments under question except for some exceptions such as widely-held and traded instruments and instruments that pose low or nil risk from a hybrid mismatch perspective.\(^{91}\)

3.2.3.2. The ‘top-down’ approach

Under the ‘top-down’ approach, the draft rules should be applicable to all transactions involving hybrid instruments. However, some exceptions are made. The top-down approach excludes the following instruments from its scope: widely held or traded instruments and instruments with nil or low risk from a hybrid mismatch perspective. An assumption can be made that these exceptions are made in order to mitigate high compliance costs of this approach.

(a) Widely held instruments\(^ {92}\)

A widely held instrument is defined as ‘one that is held by a large number of holders across a number of jurisdictions’ and includes, for example, widely-held and regularly traded bonds.\(^ {93}\) It can be assumed that widely held instruments are excluded out of the scope of the rules as it would be unduly burdensome for the taxpayer to comply with the rule as the same hybrid element can be replicated with a number of different parties.\(^ {94}\)

According to paragraph 150 of the OECD DL Draft exemption for widely held instruments is provided only for the issuer’s side of the transaction. Holders would be required to include a payment on a widely held instrument into a taxable income if the issuer was entitled to a deduction. This approach can be treated as a breach of the tax principle of horizontal equity as it will entail different tax consequences for cross-border and internal instruments: for example, although a return from the internal instrument is tax exempt under domestic law, the holder of a cross-border instrument will be taxed under an anti-hybrid rule because the issuer applied a deduction.


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(b) Traded instruments

The OECD Draft proposes to exclude traded instruments from ‘top-down’ approach in order to make it more workable. That is due to the fact that it is difficult and sometimes even impossible for the issuer of traded instruments to get information over identity of a new holder.95

(c) Instruments with nil or low risk from a hybrid mismatch perspective

The OECD DL Draft gives the following examples of such instruments: plain vanilla loans at a market rate of interest or loans made to individuals. The list of these exceptions is open and can be extended based on such criteria as: the terms of instrument, the nature of the counterparty or the circumstances in which instruments were entered into. In the opinion of the OECD DL Draft these exceptions should reduce compliance costs of the ‘top-down’ approach.

3.2.3.3. The ‘bottom-up’ approach

The ‘bottom-up’ approach contrary to the ‘top-down’ approach focuses on potentially risky arrangements. According to the ‘bottom-up’ approach the hybrid financial instruments rule should be applicable to all instruments held between related parties (including persons acting in concert) and hybrid financial instruments entered into as part of a ‘structured’ arrangement.96 Thus, the ‘bottom-up’ approach utilizes the following terms:

(a) Related parties

The OECD DL Draft suggests that the test for related party status can be set with a threshold of 10%. The parties are supposed to be related if the first person has a 10 % or greater investment in the second person or there is a third person that holds a 10 % or greater investment in both.97 A person will be treated as holding a 10 % investment in another person if that person holds directly, or indirectly through an investment in other person, 10 % of:
- the voting rights of that person. Voting rights should mean the right to participate in any decision-making concerning a distribution, a charge to the constitution or the appointment of a director; or
- the value of any equity interests of that person. Equity interests should mean any interest in a person that includes an entitlement to profits or eligibility to participate in distributions.

(b) Persons ‘acting in concert’

Paragraph 125 of the OECD DL Draft implies that not only instruments between related parties but also instruments between persons ‘acting in concert’ should be under control. This

includes ‘a person who acts together with another person in respect of ownership or control of any voting rights or equity interests’. Examples can be:
- members of the same family;
- situations when one person defines the actions of another in respect of ownership or control;
- persons that have entered into an arrangement in respect of ownership or control of any such rights or interests;
- situations when ownership or control of any such rights or interests are managed by the same person or group of persons.

(c) ‘Structured arrangements’

Paragraph 131 of the OECD DL Draft contains a sort of a ‘catch-all’ provision: transactions that generally do not fall under general rules of the ‘bottom-up’ approach, will, nevertheless, be subject to the draft rules if the instrument is a tax-motivated ‘structured arrangement.’ The OECD DL Draft provides an open list of criteria that can indicate that the parties have entered into transaction solely for purposes of tax benefits. For example, when an arrangement aims at exploiting differences in tax treatment; or when pricing of the arrangement takes into account sharing of tax benefits between parties.

As it is seen from the above, the OECD DL Draft offers a comprehensive set of rules to address the problem of taxation of hybrid financial instruments in domestic legislation. These measures should be assessed together with proposals made in the discussion draft for tax treaty regulations. In the following paragraph 3.3. of the Master Thesis I will examine provisions of the discussion draft for treaty issues.

3.3. Measures addressing hybrid finance instruments in the Discussion Draft for Treaty Issues

Two questions should be mentioned as regards to the OECD Treaty Draft. First, whether the treaty rules should be amendment in order to solve the problem of double non-taxation of hybrid financial instruments. The second question is whether the amendments proposed by the OECD DL Draft affect the provisions of bilateral tax treaties. These questions will be studied further in relation to OECD MC as a model tax treaty.

As it was noted before, non-taxation of hybrid financial instruments is attributable to interplay of countries’ purely domestic law. Measures of the OECD DL Draft are composed on a stand-alone basis without reliance by each counterparty on the other contracting jurisdiction. This proves that in the opinion of the OECD the domestic measures are expected to be sufficient in order to treat the problem of

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mismatching tax consequences of hybrid financial instruments without addressing to the provisions of bilateral tax treaties. This conclusion can be confirmed by paragraph 12 of the OECD DL Draft. It stipulates that:

‘the potential for conflict between domestic hybrid mismatch rules and the outcomes provided for under the OECD Model Convention depends, to a significant extent, on the manner in which the domestic rules go about neutralising the tax consequences under the arrangement. Hybrid mismatch solutions that focus on denial of deductions in the payer state and/or forcing the inclusion in the payee state are domestic law solutions imposed on domestic taxpayers and, at first glance, would not appear to implicate the taxing rights of other states.’

It is also important to mention that the OECD MC does not regulate the question of deduction of expenses (except for Articles 7 ‘Business profits’ and 24 ‘Non-discrimination’). The Commentary to the article 7 of the OECD MC prescribes that whether deduction of expenses is allowed should be solved by domestic laws of the state (paragraph 30 to the Article 7 of the Commentary).

As all above rules are in scope of domestic legislation, Article 23 is the only provision of the OECD MC that may be affected by the OECD DL Draft rules as it refers to questions of elimination of double taxation. This is due to the fact that the OECD DL Draft utilizes special rule for systems with tax exemption for dividends. This conclusion is confirmed in paragraphs 15, 16 of the OECD Treaty Draft. To assess the effect of OECD DL Draft on the OECD MC we should refer to article 23 A and article 23 B of the mentioned convention.

(a) Article 23 A

According to paragraph 2 article 23 A of the OECD MC, ‘where a resident of a Contracting State derives [dividend or interest] income which may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State.’ In other words, in case of cross-border dividend income it is the credit and not the exemption method which is applicable. Thus, recommendations of the OECD DL Draft will not affect the OECD MC (this point of view is set forth in paragraph 18 of the OECD Treaty Draft).

However, some states may enter into a tax treaty which does not follow the OECD MC and which provides for dividends exemption. In this case the OECD Treaty Draft proposes that parties to the treaty should consider the inclusion of paragraph 4 of Article 23 A into their treaty or even switch from the exemption to credit method.

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101 Paragraph 4 of the Article 23 A states that ‘The provisions of par 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of the Convention to exempt such income or capital from tax or applies the provisions of par 2 of Article 10 or 11 to such income.’ This paragraph concerns the situations of double non-taxation when a state of source is not entitled to tax income whereas the state of residence leaves the taxing rights to the source state due to the inconsistent treatment of facts of the case by both states (par. 56.1 of the Commentary to the article 23 A of the OECD MC)
(b) Article 24

The OECD Treaty Draft (paragraph 23) concludes that measures proposed by the OECD DL Draft do not raise issues of discrimination based on nationality (Article 24(1) of the OECD MC). They also do not appear to treat permanent establishments differently from domestic enterprises (Article 24(3) of the OECD MC, to provide different rules for the deduction of payments made to residents and non-residents (Art. 24(4) of the OECD MC) or to treat domestic enterprises differently based on whether their capital is owned or controlled by residents or non-residents.

As it follows from the above analysis, measures that are aimed at treating the problem of double non-taxation of hybrid financial instruments are concentrated in the OECD DL Draft and do not require changes of double tax treaties. This conclusion is stated in paragraph 17 of the OECD Treaty Draft.

3.4. Conclusions

The OECD DL Draft proposes a wide scope of rules for regulation of taxation of hybrid financial instruments. These rules seem to change the existing tax regime of hybrid financial instruments sufficiently.

Thus, the OECD DL Draft proposes the so-called ‘primary’ and ‘secondary’ ‘linking rules’ according to which the deduction under hybrid financial instrument should be allowed only in one jurisdiction: either jurisdiction of the payer or jurisdiction of the payee. Special rule for systems with dividend exemption is introduced by the OECD DL Draft: the dividend exemption should not be granted to the extent the payment is deductible under the laws of the issuer’s jurisdiction.

The OECD DL Draft offers two approaches for tax treatment of hybrid financial instruments: the ‘top-down’ and the ‘bottom-up’ approaches. The difference is that the first approach has a ‘catch-all’ character as all hybrid financial instruments fall within its scope. However, some exemptions are provided in order to simplify it and to make it workable. Thus, widely held and traded instruments, as well as instruments with nil or low risk fall out of scope of the ‘top-down’ approach.

The ‘bottom-up’ approach aims at the arrangements between related parties and parties ‘acting at concert’. However, rules of this approach are extended to structured arrangements between unrelated parties, i.e. arrangements that are constructed solely for tax reasons.

The OECD DL Draft has no single opinion as to what approach should be taken as basis for regulation of taxation of hybrid financial instruments in cross border situations. Both approaches proposed by the OECD DL Draft have their strong and weak points which will be assessed in the Chapter 4 of this Master Thesis.

As it follows from the above analysis, measures that are aimed at regulating of utilization of hybrid financial instruments in tax planning are concentrated in the OECD DL Draft. The OECD Treaty Draft provides an assessment of the effect of newly proposed domestic measures on the provisions of
double tax treaties. The OECD Treaty Draft proves that, as a general rule, the problem of double non-taxation of hybrid financial instruments should be solved without intervention into treaty provisions. Exception is made, however, for the treaties that utilize dividend exemption scheme: in this case the OECD Treaty Draft advises to include paragraph 4 of Article 23 A of the OECD MC into the treaty.

As it was stated above, chapter 3 of this Master Thesis contains description of the rules proposed by the OECD DL Draft and by the OECD Treaty Draft. In order to answer the research question these rules should be assessed against principles of ‘good design’ as the OECD DL Draft refers to them. The following Chapter 4 is dedicated to this analysis.
4. Correspondence of proposed rules to principles of ‘good design’

The OECD DL Draft provides a set of criteria which are addressed as criteria for ‘good design’ for hybrid mismatch rules. In the opinion of the OECD only measures which meet the above criteria can be adopted. I will describe these criteria in the following paragraph 4.1. of the Master Thesis. Rules for tax regulation of hybrid financial instruments will be assessed against criteria for ‘good design’ in paragraph 4.2. of the Master Thesis.

As it will be seen from the further analysis some ‘good design’ principles are closely connected. Taken this into account, closely related principles of ‘good design’ will be further combined and discussed together for the purposes of more logical representation of the analysis.

4.1. Criteria for assessment of draft rules

4.1.1. Comprehensive, clear and transparent character of the rules; implementation flexibility

(a) *Comprehensive character of the rules.* It is an important criterion as non-comprehensive measures instead of treating tax problems connected with hybrid financial instruments can, on the contrary, create further opportunities for tax planning. The OECD DL Draft explains that a measure should be treated as comprehensive if it is based on the ‘stand-alone’ approach, i.e. rules of a single jurisdiction should be complete and should not be dependent on the rules of any other jurisdiction.

(b) *Rules should be clear and transparent in their operation.* Rationale behind this principle is that new rules for tax regulation of hybrid financial instruments suppose close interrelation between laws of different jurisdictions. Consequently, in order to make the application of the rules efficient these rules should be clear and understandable for the companies and tax authorities of the counter jurisdiction.

(c) *Rules should achieve consistency while providing implementation flexibility.* This principle supposes that:

- rules should operate on the same entities and payments. Following the OECD DL Draft this can be achieved by utilization of neutral terminology by the rules;
- rules should be flexible enough in order to fit the existing legal system of each jurisdiction.

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- rules should take into account potential constraints under national and international law. ¹⁰⁷

**4.1.2. Principle of automatic application**

*Rules should apply automatically*, i.e. without any special exercise of tax authorities. The OECD DL Draft explains that automatic character of the rule is necessary as, otherwise, coordination between tax authorities will be required which will increase the cost for tax compliance; ¹⁰⁸

**4.1.3. Principles for rule targeting and coordination**

(a) *Rules should target the mismatch rather than focusing on establishing in which jurisdiction tax benefit arises.* The OECD DL Draft calls for elimination of tax mismatch outcomes, without establishing that jurisdiction has lost tax revenues under the arrangement. ¹⁰⁹ The DL Draft explains that new rules should deprive taxpayers of the intention to use hybrid mismatch arrangements as such. This, in the opinion of the OECD DL Draft, will lead to less complicated and more transparent tax structuring. ¹¹⁰

(b) *Rules should be coordinated to avoid double taxation.* According to the OECD DL Draft the rules should be applicable up to extent that is necessary to address the mismatch. The following levels of coordination are set forth: ¹¹¹

- coordination of the hybrid mismatch rules applied by each contracting jurisdictions;
- coordination with the rules of domestic tax system;
- coordination with the rules of third jurisdiction;
- coordination of hybrid mismatch rules between themselves and with specific anti-abuse and re-characterization rules. ¹¹²

**4.1.4. Principle of minimum disruption to existing domestic law**

In the opinion of the OECD DL Draft this principle can be achieved if new hybrid rules do not more than simple alignment of the tax consequences of hybrid mismatch arrangements; new rules should not address the characterization of the instrument.

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4.1.5. Easiness for administration by tax authorities; workable character for taxpayers

(a) *It should be easy for tax authorities to administer the rules.* 113 The OECD DL Draft supposes that this principle is closely connected to rule for automatic application; automatic implementation on a self-assessment basis will not raise significant administration costs for tax authorities. Also this principle is closely connected to the principle for clear and transparent rules: the rules can apply automatically and without additional costs only in case when both – taxpayers and tax authorities – are not obliged to make qualitative judgments about whether an arrangement is within the scope of the rules. 114

(b) *Rules should be workable for taxpayers.* According to the OECD DL Draft this principle is also reflected in minimization of compliance costs of taxpayers. 115 It is interesting and essential for the purposes of the following analysis that the OECD DL Draft states that a rule which targets all instruments ‘will impose compliance costs [even] on taxpayers who have not entered into hybrid mismatch arrangements’. 116

As it can be seen from the above, the OECD sets forth a wide range of design principles in its intent to propose all-encompassing rules. As it follows from paragraph 28 of the OECD DL draft ‘the [anti-hybrid] rules are intended to drive taxpayers towards less complicated and more transparent tax structuring.’ However, it can be assumed that it is not easy to follow all these principles even if judged solely from their amount not speaking about their complicated character and ambitiousness of their aim.

In the following paragraph the rules proposed by the OECD DL Draft will be assessed against principles for ‘good design’.

4.2. Correspondence of the draft rules to the principles of ‘good design’

It was mentioned above that some design principles are closely connected to each other. Thus, the purpose of assessment of the rules against principles for ‘good design’ these principles will further combined in the same way as in paragraph 4.1. of the Master Thesis. Due to the fact the both public discussion drafts have been published by the OECD only several months ago, hardly any literature can be found in sources recommended for writing of the Master Thesis. The following analysis of the OECD DL Draft rules will be supported with opinion of leading (tax) consulting companies, published as an outcome of public consultations at the web-site of the OECD. 117

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4.2.1. Comprehensive, clear and transparent character of the rules; implementation flexibility

(a) No clear definitions for terms used in OECD DL Draft

Definitions provided by the OECD DL Draft are ambiguous. First, the entire definition of a hybrid financial instrument is unclear. Even the OECD is not confident whether this definition is workable and asked the public to deliver an opinion about it. As it follows from the analysis undertaken in the subparagraph 3.2.1. of this Master Thesis: 1) all debt and equity instrument are included into definition; 2) definition of hybrid financial instrument utilizes ambiguous terms ‘ordinary income’ and ‘deductible payment’; 3) the definition of ‘financial instrument’ is open-ended which could lead to inconsistent definitions in different jurisdictions. Such vague and broad definition does not solve the problem of inconsistent classification of instruments in contracting jurisdictions.

I suppose that the definition of hybrid financial instruments for the purposes of the OECD DL Draft rules should be narrowed and should not include any instrument which is treated as debt or as equity under the rules of jurisdiction applying the rule. Thus, this definition should be narrowed to debt or equity of related parties which is supposed to lower the compliance costs (this proposal closely linked to choice of ‘bottom-up’ or ‘top-down’ approaches as viewed below).

Hybrid financial instruments are defined in OECD DL Draft via terms ‘ordinary income’ and ‘deductible payment’ which do not have a clear definition in the draft. Unclear definition of ‘ordinary income’ may result in uncertainty when, for example, the recipient jurisdiction may subject the item to a different tax rate or certain limitations from those that apply to other types of income.

The OECD DL Draft is not clear enough as regards to definition of ‘deductible payment’. The draft leaves open the question whether the deduction should be utilized in reality or whether the draft addresses any ‘theoretical’ possibility to deduct expenses. Therefore, the rule should be specified in this respect. It can be assumed that only deductions that de facto reduce taxable income of the payer should fall under the draft rules (as in this case such deduction will lead to a mismatch in tax outcomes).

The draft leaves unanswered the question about evidences that can prove that the payment was either non-deducted in the payers state, or was included into ordinary income of the recipient. In this respect it seems necessary for the draft to provide more detailed rules.

It can be concluded that the OECD DL Draft should provide more clearance as regards to definitions used as they form basis for the draft rules.

(b) Linking rules

As it follows from the analysis undertaken in subparagraph 3.2.2. of the Master Thesis, the linking rules are not clear and transparent. The fact that the OECD DL Draft links contracting jurisdiction by setting interdependence in proposed rules may entail that some countries will fail to implement the proposed measures (inter alia due to their complexity) but will rely on other countries’ actions. That will not be consistent with the OECD approach for cooperation in actions against hybrid mismatch arrangements.
The Draft sets primary and secondary rules, however, provides no guideline as regards to whether it is a payee or payer who has to determine the applicable rule.

Another issue that is worth mentioning is that the two-step approach may, increase the risk of double taxation and add to the complexity of the rules, as result of two or more jurisdictions denying deduction or requiring inclusion of the same payment in the taxpayer’s ordinary income.

I suppose that in order to mitigate the above negative outcomes the OECD DL Draft should limit the proposed rules to either primary or secondary rule.\textsuperscript{118}

(c) Rules for ‘bottom-up’ approach

This approach entails utilization of a wide number of descriptive categories such as ‘related parties’, ‘parties acting in concert’, ‘structured arrangements’.\textsuperscript{119} Definitions of these categories provided by the OECD DL Draft do not meet criteria for clear and transparent rules. Moreover, unclear list of qualifying features for arrangement to be qualified as ‘structured’ makes this approach complicated.\textsuperscript{120} Thus, definitions of ‘parties acting in concert’ and ‘structured arrangements’\textsuperscript{121} should be clarified, particularly should include some examples.

(d) Rules for ‘top-down’ approach

Rules for ‘top-down’ approach satisfy such criterion as a comprehensive character of the rules: this approach puts all hybrid financial instruments under control, and, thus, ensures a cover-all character of the rules. Whether such a broad character is in line with other design principle is studied in the following subparagraphs.

The ‘top-down’ approach as compared to the ‘bottom-up’ approach does not contain such descriptive categories as ‘related parties’ or ‘structured arrangements’. However, it utilizes its own categories such as ‘widely held or traded instruments’, ‘instruments with nil or low risk from a hybrid mismatch perspective’, which definitions are left open.

The ‘top-down’ approach seems to be very broad as it covers all hybrid financial arrangements. The main issue of concern which is invoked by this approach is that it seems to be not in line with the aims of the BEPS Action Plan. As it noted above, the OECD BEPS Action Plan targets not all hybrid financial instruments but only those which are utilized in tax planning and which entail mismatch in tax consequences. Hybrid instruments are widely used on capital markets and not exclusively for purposes of tax optimization.

\textsuperscript{118} In the commentary to the OECD DL Draft issued by PwC the preference is given to the primary rule. Commentary of PwC, ‘Comments received on Public Discussion drafts BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements’ (7 May 2014), page 412, http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf


\textsuperscript{120} Commentary of Ernst & Young, ‘Comments received on Public Discussion drafts BEPS Action 2: Neutralise the Effect of Hybrid Mismatch Arrangements’ (7 May 2014), page 185, http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf

In this respect, the ‘bottom-up’ approach seems to be more consistent with the aims of the BEPS Action Plan than the ‘top-down’ approach which scope is too broad. Also the ‘bottom-up’ approach seems to be less commercially disruptive.\(^{122}\) However, even under the narrower ‘bottom up’ approach, the proposed rules would apply to all related-party instances. At the same time, even if the instrument is issued between related parties it does not mean that this instrument entail mismatch in it tax outcomes. Thus, the proposed recommendations could negatively impact on global trade and investment in an unforeseen manner.\(^ {123}\) A point of view can be found, that in order to mitigate these consequences, a purpose or motive test should be included into the scope of rules.\(^ {124}\) In my opinion, however, this test will increase compliance costs of the rules.

It can be concluded from the above, that the draft rules do not meet the criteria for clear and transparent rules. First, the OECD DL Draft does not provide a clear definition of hybrid financial instruments. Then, definitions utilized by both, the ‘top-down’ and by the ‘bottom-up’ approach are ambiguous. Design principle for implementation flexibility supposes that rules should utilize neutral terminology\(^ {125}\) and, thus, be flexible enough to fit the existing legal system of each jurisdiction. It may be assumed that utilization of vague definitions by the OECD DL Draft is caused by its desire to provide universal rules that can fit into exiting legal systems of all countries. However, in my opinion, it is doubtful that this aim can be achieved in this way. On the contrary, broad and unclear definitions can increase inconsistence of rules applied by contracting jurisdictions. The OECD DL Draft rules are ‘exceedingly complex’\(^ {126}\) and this does not serve the aims of clearness and transparency of the rules.

4.2.2. Principle of automatic application

The OECD DL Draft explains the necessity of this principle by the assumption that any ‘non-automatic’ implementation will end up in avoidance of these rules.\(^ {127}\)

I should agree with the point of view expressed in the commentary of KPMG for discussion drafts. It is stated that ‘for rules to apply automatically in practice, taxpayers must be able to determine whether the rules apply to a given transaction or arrangement. The bottom-up approach better enables taxpayers to make that determination, because under that approach the rules would be limited to situations in which the taxpayer knows or should know that the rule applies (assuming reasonable scope for the definition of related parties, acting in concert, and structured arrangement). By contrast, in an unrelated


party context, taxpayers may not be able to obtain the information they need to determine whether a hybrid mismatch exists and whether an exception may apply.\textsuperscript{128}

It should be noted, however, that the principle of automatic application is questionable itself as it seems to be not in line with the BEPS Action Plan objectives. The BEPS Action Plan targets tax planning arrangements that may result in a reduction of the overall tax paid. It is questionable why the above design principle prescribes to address all hybrid financial arrangements despite of the fact whether they result in loss of budget revenues.

Thus, I suppose that not the Draft rules but this design principle should be reviewed. The principle of automatic application increases uncertainty of business decisions for taxpayers as their tax treatment will be put under factors beyond their control, i.e. how a foreign jurisdiction treats a financial instrument for tax purposes.

4.2.3. Principles of rule targeting and coordination

The OECD DL Draft rules meet the criterion for rule targeting as the rules focus on mismatch itself rather than on establishing in which jurisdiction the tax benefit arises. However, the OECD DL Draft provides little coordination as regards to rule coordination. This principle supposes coordination at four levels mentioned in subparagraph 4.1.3. of the Master Thesis. This principle is met only in part at the level of coordination by each contracting jurisdictions. This coordination is achieved by introduction of the ‘ordering rule’. It means that if two jurisdictions have the same rules and the problem of hybrid mismatches can be solved more efficiently by mean of one jurisdiction, the rules of the second jurisdictions should not be applicable.\textsuperscript{129}

The next issue that causes concerns as regards to the level of rule coordination was discussed in subparagraph 3.2.2. of the Master Thesis: the OECD DL Draft provides no recommendations regarding the choice between the ‘primary’ and the ‘secondary’ linking rules.\textsuperscript{130}

The OECD DL Draft provides no recommendations as to how the coordination of new rules with the rules of domestic tax system and with the rules of third jurisdiction can be achieved.\textsuperscript{131}

The next important question as regards the principle of rule coordination is that the OECD DL Draft rules should be in line with specific anti-abuse and re-characterization rules.\textsuperscript{132} It was stated above that outcomes on the Action 2 of the BEPS Action Plan, are expected earlier than outcomes on other


\textsuperscript{129} Paragraph 34 of the Discussion Draft ‘BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ (2014) International Organizations’ Documentation IBFD


Actions. However, Acton 2 is closely related to other Actions. Different timing span for outcomes for rules on tax treatment of hybrid financial instruments and other BEPS issues such as rules for controlled-foreign corporations (Action 3), limiting base erosion via interest deduction and other financial payments (Action 4) and other actions makes it questionable whether the new rules will be in line with specific anti-abuse and re-characterization rules.

One of the main issues of concern as regards to rules coordination is connected with the necessity for the rules to be implemented simultaneously within a wide number of jurisdictions. If this is not achieved, then early adopters may effectively reduce their competitiveness and lose tax revenues if businesses choose to restructure their operations to jurisdictions where the recommendations have not been implemented.

The OECD DL Draft contains no guideline for simultaneous application of the rules. However, this issue should be addressed in the OECD DL Draft as lack of coordination in implementation of the rules can mitigate their effectiveness. This point of view is supported, for example, in commentary of Deloitte LLP.

In my opinion, it is necessary to state some transitional period as simultaneous application of rules by all jurisdictions is hardly to be achieved. Also a close coordination of countries’ actions in adoption of new rules is required.

4.2.4. Minimum disruption to existing domestic law

According to this principle, the OECD DL Draft rules should not go beyond what is necessary. New rules should do not more than simple alignment of tax consequences of hybrid mismatch arrangements.

However, the OECD DL Draft offers rather radical measures. It is hard to believe that they can be implemented into domestic law without sufficient changes of the legal systems of the countries concerned. Especially if speaking about countries which apply participation exemption method.

The drafts’ rules propose to deny participation exemption for dividend which has given rise to a deduction. In essence, this rule offers to abolish exemption system in the favor of credit system.


rule does not correspond to the principle of non-disruption of existing domestic law as will require sufficient change of domestic rules for the countries which apply dividend exemption system.

The denial of the participation exemption on hybrid financial instruments which are in principle treated as equity from a local tax perspective would destroy the basic principles of tax system of such countries. Also the draft rules should not be applicable to the creditors which are tax exempted by reasons of their special status as this will damage domestic law system of the borrower’s jurisdiction.

Paragraph 241 of the OECD DL Draft states that the draft linking rules should apply before any general non-transaction specific rules (such as thin capitalization rules) as they alter the specific tax effects of a particular transaction. However, this increases disruption to other domestic law rules. For example, if the primary rule is not applied to a disregarded hybrid entity payment, the deduction of the payment may still be denied pursuant to thin capitalization rules in the payer’s jurisdiction. However, since the primary rule was not applied in the payer’s jurisdiction, the secondary rule would have to be applied in the payee’s jurisdiction thus obliging the payee to include the payment as ordinary income. The result would be that the payment would not be deductible for the payer while the payee is taxed on the payment. Consequently economic double taxation would arise on the payment.

It should be also mentioned that domestic legal systems have already set of rules against abusive tax planning, including by means of excessive interest deduction. Thus, the provisions of the OECD DL Draft should be coordinated with these rules and with outcomes on other BEPS Actions as stated above.

4.2.5. Easiness for administration by tax authorities; workable character for taxpayers

These principles imply that new rules should keep compliance costs on taxpayers to a minimum and should be easily administered by tax authorities. Based on the above analysis a conclusion can be made that the OECD DL Draft does not meet these principles.

First, as it was stated above, the OECD DL Draft contains a number of categories which description is uncertain or questionable. This cannot ensure easiness in application of the rules. To give an example, the rules for the ‘bottom-up’ approach utilize definition of ‘related parties’. However, the test for related party status is set at a relatively low threshold of 10% which may affect portfolio investors. The low threshold will entail compliance difficulties for business, whereas the likelihood of base erosion at such affiliation level does not seem to be high.

Solution here should be in increase of the level of participation or in adoption of definition of ‘related parties’ based upon degree of control – i.e. whether the level of participation affects the decisions between parties.


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The ‘top-down’ approach utilizes such terms as ‘widely-held or traded instruments’ and ‘instruments with no or low risk’. It is hard to expect that implementation of such broad terms will go along with easiness of practical application of the rules.

Second, the ‘top-down’ approach due to its broad scope will entail high compliance costs on business and administration expenses for tax authorities as it requires obtaining information about tax treatment of each and every instrument in the contracting jurisdiction.\(^{142}\)

The ‘bottom-up’ approach is supposed to entail less compliance burden as it addresses a narrower range of financial instruments than the ‘top-down’ approach\(^{143}\) and in this respect seems to be more preferable.\(^{144}\) However, two issues may sufficiently increase compliance costs here. First, the suggested threshold for related parties (10%) which was already addressed above Second, transactions between ‘parties acting in concert’ and ‘structured arrangements’ fall under control under this approach which enlarges the scope of the ‘bottom-up’ rules. Unclear list of features for arrangement to be qualified as ‘structured’ makes this approach complicated. The definitions of ‘parties acting in concert’ and ‘structured arrangements’ should be clarified, particularly should include some examples.

A high level of complexity of the rules creates a significant risk that the OECD DL Draft will prove to be too difficult to administer in practice, for both tax authorities and taxpayers.\(^{145}\)

The last issue that should be mentioned here is that the rules of the OECD DL Draft suppose that both – business and tax inspectors – are familiar with rules of other jurisdictions for tax treatment of hybrid financial instruments. However, it seems hardly to be achieved and, thus, entails that both tax authorities and taxpayers will have to obtain legal advices on that issue, which means increase of compliance and administration costs.\(^{146}\)

### 4.3. Conclusion

The OECD DL Draft needs further development. It can be observed starting from the definition of hybrid financial instruments. This definition comprises categories that should be clarified (for example, ‘deductible payments’, ‘ordinary income’).

The DL Draft offers two rules addressed as ‘primary’ and ‘secondary’ rules and offers special provisions for dividend exemption system. As it is seen from the above analysis these rules should be elaborated.


Two approaches for tax regulation of hybrid financial instruments can be found in the OECD DL Draft – these are the so-called ‘top-down’ and ‘bottom-up’ approaches. The DL Draft has no single opinion as to what approach should be taken as basis for regulation of taxation of hybrid financial instruments in cross border situations. All hybrid financial instruments (except for widely-held or traded instruments or instruments with nil or low risk) are under attention of the first named approach. The ‘bottom-up’ approach is more specified: the basic rule is that only financial instruments between related parties should be under control. However, exceptions to this rule make the ‘bottom-up’ approach somewhat wider: even instruments between non-related parties can be put under concern, as for example, in case of structured arrangements. Both approaches proposed by the OECD DL Draft have their strong and weak points and require further elaboration.

As it follows from the above analysis, measures that are aimed at treating the problem of utilization of hybrid financial instruments in tax planning are concentrated in the OECD DL Draft. The OECD Treaty Draft proves that measures offered by the OECD DL Draft should not affect provisions of bilateral tax treaties. The main issue of concern as regards to OECD Treaty Draft is connected with treaties that utilize dividend exemption scheme: the draft advises to include paragraph 4 of Article 23 A of the OECD MC into the treaty. Some challenges can arise caused by departure from the standard versions of Articles 23A and 23 B of the OECD MC in the context of recommendation that exemption for dividend income denied where the dividend is deductible for the payer.147

Taken into account all above remarks made to the provisions of OECD DL Draft and OECD Treaty Draft I cannot conclude that rules proposed by the above drafts meet criteria ‘good design’ and can be practically implemented or the purposes of mitigating mismatch tax outcomes of hybrid financial instruments.

5. Conclusion

5.1. General aspects

Utilization of hybrid financial instruments in tax planning arrangements is a topic of sufficient relevance nowadays. Governments are concerned about loss of tax revenues and hybrid financial instruments are blamed to have contributed into this process.

Implementation of hybrid financial instruments into tax planning is based on mismatches between law systems of the parties involved: whereas one jurisdiction treats instrument as a debt-like and, consequently, allows deduction of interest expenses, the second jurisdiction treats the same instrument as an equity which entails more beneficial taxation of income under instrument compared to interest income.

Mismatches in regulations of hybrid financial instruments in cross-border arrangements are explained by the fact that each jurisdiction has its own number of rules for classification of the instrument as debt or equity which may vary significantly. However, the following main approaches are implemented most widely in practice: classification based on the form of the instrument; ‘substance over form’ doctrine; ‘bifurcation’, or division of the instrument into the debt and equity parts; treatment based on accounting rules.

Thus, as it follows from the above, classification of debt and equity for tax reasons lies in the area of national civil law or accounting rules. Therefore, elaboration of a standard set of rules for all jurisdictions in order to regulate tax issues of the cross-border hybrid financial arrangements seems to be a complicated issue. However, the problem of mismatch taxation of hybrid financial instruments can be solved only by means of international cooperation. The most prominent attempt in this respect was made by the OECD which published a number of documents that address the problem of taxation of cross-border hybrid financial instruments. The most recent documents are: ‘Action Plan on Base Erosion and Profit Shifting’ and report ‘Addressing Base Erosion and Profit Shifting’.

These documents set forth the frames for future alteration of tax regulations of hybrid financial instruments. The above OECD documents have a general character. Two discussion drafts, published by the OECD in March 2014 are more interesting in this respect. These drafts, namely - the first Discussion Draft called ‘Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ and the second Public Discussion Draft called ‘Neutralise the effects of Hybrid Mismatch Arrangements (Treaty Issues)’ offer a set of rules that can be taken as a basis for tax regulation of hybrid financial instruments.

However, the result of public discussion of the above drafts shows that measures proposed by the OECD are far from their final version. The OECD elaborated a number of principals of ‘good design’ for rules. In this Master Thesis the drafts’ rules were assessed against these principals as, according to the OECD, only rules that correspond to these principles can be implemented for the purposes of tax regulation of hybrid financial instruments.
5.2. Outcome of the analysis of draft rules

The undertaken analysis shows that the OECD drafts’ rules are complicated and controversial in some parts. These rules do not meet the principles of ‘good design’. However, it is worth saying that some design principles themselves contradict to the spirit and aims of the BEPS Action Plan. For example, design principle for application of rules without requirement to establish loss of tax revenue seems to be not in line with the BEPS Action Plan objective. The latter stipulates that it is aimed not at all mismatches but rather at tax planning arrangements that may result in a reduction of the overall tax paid. Such a broad design principle can contain a potential overkill for the utilization of hybrid financial instruments as such. However, these instruments may have pure business aims and it is not correct to assess each fact of implementation of hybrid financial instrument as a pure tax structuring arrangement.

The analysis undertaken in this Master Thesis allows concluding that the drafts’ rules should be further elaborated. The following issues should be taken into account.

The OECD should not offer both ‘primary’ and ‘secondary’ rules as this may foster the situations when jurisdictions will escape implementation of new rules and will rely that the second contracting jurisdiction will solve the problem of taxation of hybrid financial instruments by own means.

The other aspect that should be noted when speaking about the draft rules is their complicated character. The rules are based on a set of descriptive categories such as ‘ordinary income’, ‘deductible payment’, ‘parties acting in concert’, ‘structured arrangements’, that have an ambiguous or open definitions. For reasons of law accuracy it is necessary to provide tax authorities and business with more clear and standardized definitions. Elaboration of the above terms by each jurisdiction will increase rather than solve the problem of mismatches in tax outcomes.

The OECD offers two approaches for regulation of hybrid financial instruments – the ‘bottom-up’ or ‘top-down’ approaches. I assume that only one approach should be implemented in practice and the choice should be made in favor of ‘bottom-up’ rules. That is because the ‘top-down’ approach seems to be too broad; it implies high compliance costs. Although the ‘bottom-up’ approach seems to be more preferential its rules should be elaborated. First, the threshold for related parties should be increased; second, categories ‘parties acting in concert’ and ‘structured arrangements’ should be clarified and narrowed because according to current wording they seem to be a sort of ‘catch-all’ provisions.

According to the principles of ‘good design’ the OECD DL Draft should impose as little disruption to domestic legislation systems as possible. However, the current version of drafts’ rules makes it hard to believe that this principle can be met without alteration of the proposed rules. For example, the rules propose to deny participation exemption for dividend which has given rise to a deduction. The denial of the participation exemption on hybrid financial instruments which are treated as equity from a local tax perspective would destroy the basic principles of tax system of such countries.

The next important issue that should be noted in respect of draft rules is that they do not contain any transitional clauses. However, it is unlikely that all countries will be able to implement the rules at the same date. This will entail a lot of issues of non-taxation or double taxation of hybrid financial instruments.
Rules proposed by the OECD under Action 2 of the OECD BEPS Action Plan are closely connected to other actions, such as rules on Controlled Foreign Companies (Action 3), Interest Deductions (Action 4), Harmful Tax Practices (Action 5). However, completion of work on Action 2 is scheduled on September 2014, i.e. on the date earlier than completion of work on other issues. It seems necessary to bring the outcomes of work on all Actions in line to each other.

The analysis undertaken in this Master Thesis shows that the problem of taxation of hybrid financial instruments can be addressed only at the international level. However, the rules proposed by the OECD in Discussion Draft called ‘Neutralise the effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)’ and Discussion Draft called ‘Neutralise the effects of Hybrid Mismatch Arrangements (Treaty Issues)’ at their current wording do not seem to be able to regulate this issue. The drafts should be further elaborated taken into account all the above mentioned aspects.
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