Tumbling tower?

Bill Dodwell reviews the use of hybrid entities by multinationals and the OECD’s proposals to bring their use to an end

KEY POINTS

- **What is the issue?**
  The use of hybrid entities and hybrid instruments to achieve double deductions, or non-taxation of income, has grown over the past 20 years. The OECD considers that action should be taken globally to remove the effect of hybrids – and that a ‘purpose’ test won’t achieve this.

- **What does it mean to me?**
  Linked rules should apply, which would work even if only one party to the hybrid had legislated them. A primary rule could disallow a deduction, with a secondary rule that would tax the equivalent income should the paying country not have enacted the primary rule.

- **What can I take away?**
  There is a case for treating banks and insurers separately in relation to regulatory capital, but not if this allows multiple deductions. The G20 will receive the OECD advice at its September 2014 meeting and will then decide whether to adopt the proposals.

One of the most common issues in international tax planning over the past 40 years – and probably much longer – concerns how a multinational should finance an overseas subsidiary. The choices are relatively simple: equity, related-party debt, or third-party debt. Most countries have tax rules that require a minimum of equity in relation to debt – and there’s some commercial common sense as well. Assuming that there are taxable profits, the simplest form of planning considers the comparative tax rates in the lender and borrower countries.

Tax rules and tax rates are not the same everywhere in the world – which has opened up opportunities for more imaginative planning. One example, which has been common for UK multinationals since the original controlled foreign company rules arrived in 1984 – involves capitalising an overseas finance company with equity, such that it can lend to overseas operating companies. The Netherlands was involved in many early structures, because it had a system for agreeing a low ‘spread’ where loans were made to a Dutch company which in turn lent the money elsewhere. The Dutch don’t have a domestic withholding tax on interest either, so payments could be made to a tax haven. The papers for the Cadbury Schweppes hearing about the EU freedom of establishment and CFC legislation reveal a 1980s strategy involving loans from a Jersey finance company to a Dutch company, which in turn lent to other parts of the group. Strategies such as this will have reduced the cost of financing overseas operations.

The next step in developing financing structures took inspiration from the US entity classification rules. US law forms its own view on whether a non-US entity should be regarded as a company or as a partnership or branch. It was relatively easy to set up a UK company with sufficient characteristics that the US considered it as a partnership. The fertile minds of US tax specialists used this mismatch to achieve one-sided deductions (a deduction without income recognition), or double deductions. US simplicity then arrived with the ‘check the box’ rules which allow US multinationals to determine the categorisation of most foreign entities.

Multinationals then had a choice of strategy. They could invest in a country which levied a low rate of tax, either through its national rate, allocation to a third country branch which itself levied little tax, or through deemed deductions. Alternatively, multinationals could achieve a similar effect through using a hybrid instrument, or a hybrid entity. Some countries allow tax deductions for the costs of servicing profit-participating loans.

Other countries exempt from tax the income on that basis that it is a dividend. Perhaps the best-known financing structure used by UK companies investing in the US is the so-called ‘tower’ structure. At its simplest, it looks something like the diagram in Table 1.
The lower level UK company pays interest on the loan to the top UK company. For UK purposes, the interest income is offset by the interest expense under normal group relief rules — so there is no net taxable income. For US purposes, the UK subsidiary is a disregarded entity, so its interest expense is taken as a deduction in the US parent and, through the US consolidated tax return, offset against trading profits in the US subsidiary. The UK company sandwiched in the US group is a hybrid entity, in that it is regarded as a company in the UK and as a branch in the US. The result is that two deductions are claimed for a single payment of interest. At present the UK and US tax authorities both accept the structure in the right circumstances — and some have received confirmation from the UK that its anti-arbitrage provisions do not apply. The UK’s anti-arbitrage provisions are a form of anti-hybrid rule. They apply to both deductions and receipts, and were introduced in 2005 ‘to counter such contrived arrangements to avoid UK tax’, as HMRC put it. However, they limit deductions only where the purpose of the arrangement is to reduce UK taxation. The UK also has rules which deny the normal dividend exemption where the payment of the dividend is tax-deductible to an overseas payor. Most countries do not allow tax deductions for dividends, but Australia is one example where dividends on qualifying preference shares are deductible as a finance cost. The UK also has specific rules for certain types of hybrid debt used by banks and insurers, where the intention is to allow the bank/insurer a tax deduction even if the lender might treat the receipt as a tax-exempt dividend. The UK has made it clear it will continue to look at banks and insurers separately. The approach of the OECD in its Discussion Drafts on Hybrids is different. Unlike the UK, which simply asks whether the UK is being disadvantaged, the OECD starts from the place that there should be definitive rules that remove the benefit of hybrids without asking whether a particular country has lost out. The discussion draft considers hybrid entities and hybrid instruments, as well as more complex arrangements. For hybrid instruments, the document recommends that the primary response should be to deny the payer a deduction for payments made under a hybrid financial instrument with the jurisdiction of receipt applying a secondary or defensive rule that would require a deductible payment to be included in income if the payer was located in a jurisdiction that did not apply the primary rule. This approach is designed to deal with the inevitability that not all countries will change their law and, even if all do, the timing will vary.

The proposals for hybrid entities are more complicated. The double deduction rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid in the subsidiary jurisdiction and the corresponding ‘duplicate deduction’ generated in the jurisdiction of the investor. The primary rule is that the duplicate deduction cannot be claimed in the investor jurisdiction to the extent it exceeds the claimant’s dual inclusion income (income taxed by both jurisdictions). A secondary rule applies to the hybrid in the subsidiary jurisdiction to prevent the hybrid claiming the benefit of a hybrid payment against other jurisdiction. A similar approach applies where there is just one deduction but no income recognition due to hybrid effect — such as a loan to a branch where in one jurisdiction the income and deduction are both ignored.

How might all this apply to our tower structure? It’s a hybrid entity structure and the primary rule should mean that the UK could not claim a deduction for the interest expense in the UK sandwich company. If the UK does not enact the proposed rules, the US should deny the deduction under the secondary rule.

The OECD document sets out clearly that it does not propose taking action against countries which apply a low tax rate or other those with notional interest deductions — such as Belgium, Luxembourg (under its ruling practice) and, soon, Switzerland. It also is not intended to counter timing differences between countries — although, oddly, it is intended to counter arrangements where the recipient country taxes something as a capital gain. Given that most countries tax gains in a company at the same rate as income, this is surprising.

In many ways it looks odd for the OECD to consider hybrids separately from interest deductions (Action 4 – due to report by December 2015). Most hybrids are simply one financing option — and forcing a change of strategy so that a group adopts a finance company based in a country with a notional interest deduction doesn’t seem to achieve a great deal. However, it is clear that the 44 countries involved in BEPS (the OECD and G20) have a clear dislike of hybrid arrangements and wish to take action to counter them. Most of the changes here will need to come in domestic law, which causes some sceptics to doubt that anything much will happen. There’s no doubt that moves by a few countries would not be effective — and would simply put them at a competitive disadvantage. It will be interesting to see whether, when it comes to the crunch, enough countries have the appetite to unite in making changes.

The OECD is proposing that there are definitive rules which remove the benefit of hybrids without asking whether a particular country has lost out.

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**TABLE 1 – ‘TOWER STRUCTURE’**

- UK
- US
- Loan
- UK
- US

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