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"Circularly Linked" Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on a Tie-Breaker Test

Countries have rules to address the deduction of payments that are excluded from a recipient's taxable income and the non-inclusion of income deductible by a payer. If two countries have such rules and both consider the treatment in the other, the rules are "circularly linked". Could a tie-breaker test resolve this?

1. Rules Countering Deduction and Non-Inclusion Schemes

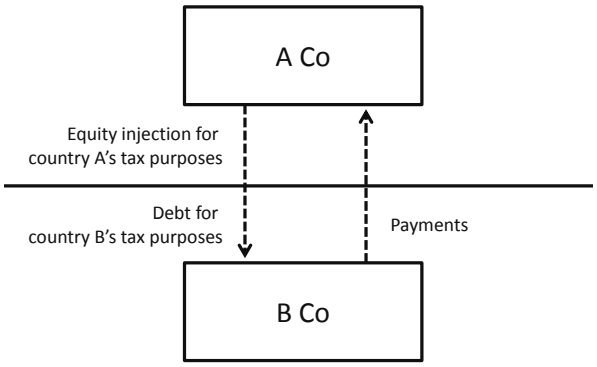
In March 2012, the OECD published a report entitled "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues"[1] (the "OECD Report"), which deals with arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries. In addition to describing the most common types of hybrid mismatch arrangements and the effects they are intended to achieve, the OECD Report summarizes the tax policy issues raised by such arrangements and the policy options to address them. Special focus is placed on domestic law rules that deny benefits in the case of hybrid mismatch arrangements and the experience of countries regarding the application of these rules.[2]

Inter alia, hybrid mismatch arrangements make use of hybrid instruments that are treated differently for tax purposes in the countries involved, most notably as debt in one country and as equity in another country. Such hybrid mismatch arrangements, or deduction and non-inclusion schemes, can give rise to a deduction in one country, typically a deduction for interest expenses, but no corresponding inclusion in taxable income in another country (*see* Example).[3]

Example

A company resident in country B (B Co) is funded by a company resident in country A (A Co) using an instrument that qualifies as equity in country A, but as debt in country B. If payments are made under the instrument, these are deductible interest expenses for B Co under country B's tax laws. The corresponding receipts are treated as exempt dividends for country A's tax purposes. As a result, there is a net deduction in country B without corresponding taxation of the income in country A.[4]

Diagram: Deduction and non-inclusion using hybrid instruments



The OECD Report concentrates on rules specifically addressing hybrid mismatch arrangements. Under such rules, the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in the foreign country, thereby eliminating the possibility of mismatches. According to the OECD Report, such rules appear to have significant potential as a way in which to address hybrid mismatch arrangements that are regarded as inappropriate.[5] In order to counter deduction and non-inclusion schemes, the following two different types of rules can be used: (1) rules that address the deduction of payments, which are not included in the taxable income of the recipient (*see* Example (continued), Alternative 1);[6] and (2) rules that address the non-inclusion of income, which is deductible by the payer (*see* Example (continued), Alternative 2).[7]

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1. OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD 2012), International Organizations' Documentation IBFD, also available at www.oecd.org/dataoecd/20/20/49825836.pdf. *See also* R. Russo, *The OECD Report on Hybrid Mismatch Arrangements,* 67 Bull. Intl. Taxn. 2 (2013), Journals IBFD; M. Nouwen, *Highlights & Insights on European Taxation* 4.3, pp. 25-26 (Kluwer 2012); A. Postma & M. Nouwen, *In the spotlight: OECD and European Union increase their focus on double non-taxation*, Ernst & Young, Global Tax Policy & Controversy Briefing 10, p. 34 (June 2012); T. Töben, *Seminar B: Grenzüberschreitende Steuerarbitrage*, 21 Internationales Steuerrecht 18, p. 685 (2012); S. Bendlinger, *Hybride Gestaltungen im internationalen Steuerrecht: der Statusbericht der OECD aus österreichischer Sicht*, 22 Steuer und Wirtschaft International 11, p. 485 (2012); and G. Kofler, *Steuergestaltung im Europäischen und Internationalen Recht*, in *Gestaltungsfreiheit und Gestaltungsmissbrauch im Steuerrecht* pp. 232-241 (R. Hüttemann ed., Dr. Otto Schmidt 2010).
2. OECD Report, *supra* n. 1, at paras. 3 and 7.
3. Id., paras. 9-11.
4. Id., paras. 16-17.
5. Id., paras. 34-35.
6. Id., paras. 45-50.
7. Id., paras. 51-57.

Example (continued)

Alternative 1

Country B introduces a rule that denies the tax deductibility of interest expenses, which are exempt at the level of the recipient due to a mismatch in treatment. Payments made under the hybrid instrument are exempt at the level of A Co, as the instrument is qualified as equity, and not as debt, under country A's tax laws. As a result, the payments are not treated as deductible interest expenses for B Co under country B's tax laws.

Alternative 2

Country A introduces a rule that denies the exemption of dividends, which are tax deductible at the level of the payer due to a mismatch in treatment. Payments made under the hybrid instrument are deductible at the level of B Co, as the instrument is qualified as debt, and not as equity, under country B's tax laws. As a result, the corresponding receipts are not treated as exempt dividends for A Co under country A's tax laws.

What happens if both countries introduce such rules countering deduction and non-inclusion schemes and, therefore, both "circularly link" the tax treatment of certain payments or receipts to the tax treatment in the other country? In other words, the country of the payer denies the deduction of the payments if the corresponding receipts are not included in the taxable income of the recipient and the country of the recipient denies the exemption of the receipts if the corresponding payments are deductible in the country of the payer. Consequently, is the deduction of the payments in the country of the payer denied while the corresponding receipts remain exempt in the country of the recipient, or is the exemption of the receipts in the country of the recipient denied while the corresponding payments remain deductible in the country of the payer, or are both the deduction and the exemption denied, thereby resulting in economic double taxation?

Problems with "circularly linked" rules would not arise if countries coordinated their rules countering deduction and non-inclusion schemes. Such mismatch arrangements can be countered either by rules that deny deduction or rules that disallow exemption. If it was recommended by the OECD that rules countering deduction and non-inclusion schemes should be applied only at the level of the payer or only at the level of the recipient and if such a recommendation was adopted by countries, there would be no "circularly linked" rules. In other words, by choosing one of the two approaches and agreeing at an international level to counter deduction and non-inclusion schemes either by way of the denial of a deduction or the disallowance of an exemption, "circular links" would be eliminated.[8] However, the OECD's Committee on Fiscal Affairs does not recommend using specific rules to counter deduction and non-inclusion schemes.[9] Rather, the OECD Report states that, in principle, rules that link the tax treatment in one country to the tax treatment in another country may require the introduction of a tie-breaker test to resolve issues that may arise when the tax laws of both countries consider the treatment in the other country. Country rules linking the domestic tax treatment to the foreign tax treatment do not generally contain a tie-breaker test where the other country involved has corresponding rules. Although this may become more relevant as more countries introduce corresponding rules, according to the OECD, it appears that, to date, this has not give rise to major issues. This is most likely due to the fact that only relatively sophisticated taxpayers engage in such arrangements and these taxpayers generally avoid using arrangements where they envisage a risk of double taxation.[10] Nevertheless, if countries continue to introduce differing rules to counter deduction and non-inclusion schemes, "circularly linked" rules could become more of a problem. Section 2. now examines whether or not and how a tie-breaker test could resolve issues of "circularly linked" rules.

2. Problems with and Solutions for "Circularly Linked" Rules

2.1. Introductory remarks

If the tax laws of two countries correspondingly refer to the tax treatment in the other country, there might never be a logical and consistent decision on the tax treatment in both countries.[11] In the country of the payer, the payments would be treated as tax-deductible interest expenses. However, such payments would not be tax deductible if the corresponding receipts are tax exempt at the level of the recipient due to a mismatch in treatment. Consequently, in order to decide on the tax treatment in the country of the payer, it is necessary to consider the tax treatment in the country of the recipient. In the country of the recipient, the receipts are treated as tax-exempt dividends. However, they become taxable income if the corresponding payments are tax deductible in the country of the payer due to a mismatch in treatment. Accordingly, in order to decide on the tax treatment in the country of the recipient, it is again necessary to look at the tax treatment in the country of the payer. But the tax treatment in the country of the payer is undecided and will again depend on the tax treatment in the country of the recipient, and so on.

In order to resolve cases of "circularly linked" rules, countries would have to introduce more sophisticated provisions to counter deduction and non-inclusion schemes, which would include a tie-breaker test. The domestic law of at least one of the countries would have to take a definite decision regarding the tax treatment to break the tie.

8. Various progress reports regarding the EU Code of Conduct Group (Business Taxation) suggest that the Group had agreed on a solution for countering deduction and non-inclusion schemes due to a mismatch in treatment of hybrid loan arrangements, most likely either by the denial of a deduction or by the disallowance of an exemption, and was debating how to implement the approach adopted, either as hard law (a directive) or soft law (guidance and/or application notes). On this, *see*, with further references, Nouwen, *supra* n. 1, at pp. 23-24; M. Nouwen, *Highlights & Insights on European Taxation* 2.1, pp. 10-12 (Kluwer 2012); *Highlights & Insights on European Taxation* 8.3, p. 29 (Kluwer 2012); *Recent results and trends reported by the Code of Conduct Group on Business Taxation*, Ernst & Young, *EU direct tax news* 46, pp. 8-9 (Nov., Dec. & Jan. 2012); and Postma & Nouwen, *supra* n. 1, at pp. 36-37. A comment in the OECD Report, *supra* n. 1, at p. 19, n. 18, appears to indicate that the agreed solution is to disallow the exemption of payments as profits distributions under a participation exemption insofar as such payments were qualified as a tax-deductible expense for the debtor.
9. OECD Report, *supra* n. 1, at p. 25.
10. Id., at para. 69.
11. *See also* N. Schmidt & K. Binder, *Chaos durch doppelten Kampf gegen doppelte Steuervorteile*, Die Presse (14 Jan. 2013), available at http://diepresse.com/home/wirtschaft/recht/1332188.

In this way, the "circular link" would be removed. In general, the following three ways of drafting such a tie-breaker test appear to be possible:

(1) by applying a rule countering deduction and non-inclusion schemes only if the other country does not provide for a corresponding rule (*see* section 2.2.);
(2) by disregarding, for purposes of the rule countering deduction and non-inclusion schemes, all of the provisions of the other country that contain a "back link" (*see* section 2.3.); or
(3) by adopting an international meaning of equity and debt and, in this way, thereby coordinating the rules of the countries countering deduction and non-inclusion schemes (*see* section 2.4.).

2.2. Solution (1)

Under solution (1), one country's rule countering deduction and non-inclusion schemes would not apply if the other country provided for a corresponding rule. It would, therefore, not be necessary for a country to apply its own rule countering deduction and non-inclusion schemes and, by so doing, to give rise to a "circular link" if the other country already provided for a corresponding rule and, therefore, the deduction and non-inclusion scheme was or could be countered by the other country. However, as soon as both countries introduce a tie-breaker test, either both rules countering deduction and non-inclusion schemes would not apply or again a "circular link" would arise. If the tie-breaker test considered the mere existence of a corresponding rule in the other country, regardless of whether or not it applied, for both countries, the other country would have a corresponding rule and, therefore, neither rule countering deduction and non-inclusion schemes would apply. The consequence would be a tax deduction of the payments without the corresponding inclusion in taxable income. If the tie-breaker test considered the fact of whether or not the other country's corresponding rule applied, as only then is the deduction and non-inclusion scheme, in fact, countered by the other country, there would again be a "circular link", but this time at the level of the tie-breaker test. One country's rule countering deduction and non-inclusion schemes would apply only if the other country's corresponding rule did not apply, and the other country's corresponding rule would not apply only if the first-mentioned rule applied. This yet again depends on whether or not the other country's corresponding rule applied, and so on.

2.3. Solution (2)

Under the solution (2), one country's rule countering deduction and non-inclusion schemes could refer to the tax treatment in the other country, but, for this purpose, it would disregard the other country's provisions that included a "back link". Accordingly, by disregarding the other country's provisions insofar as they contain a "back link", there would be a definitive decision on the tax treatment. With such a tie-breaker test, there would, therefore, no longer be any "circular link". However, if both countries introduced such a tie-breaker test into their domestic laws, both rules countering deduction and non-inclusion schemes would apply, thereby resulting in economic double taxation. As both country's rules would disregard the other country's corresponding rule and as the tax treatment under the other country's provisions that would not contain a "back link", this would entail, for one country, the deduction of payments under an equity instrument and, for the other, the tax exemption of receipts under a debt instrument, both rules would counter deduction and non-inclusion schemes. In other words, under solution (2), there would be neither a tax deduction nor a tax exemption (*see* Example (further continued)).

Example (further continued)

Country B introduces a rule that denies the tax deductibility of interest expenses, which are exempt at the level of the recipient due to a mismatch in treatment. For this purpose, however, any rule of another country that makes taxability dependent on whether or not the interest expenses are deductible in country B is disregarded. Country A introduces a rule that denies the exemption of dividends, which are tax deductible at the level of the payer due to a mismatch in treatment. For this purpose, however, any rule of another country that makes tax deductibility dependent on whether or not the dividends are exempt in country A is disregarded. For the purposes of country A's rule, it is irrelevant that the tax deductibility of the payments is, in fact, denied in country B, with country B's corresponding rule countering deduction and non-inclusion schemes as it would be disregarded, as it contains a "back link". As, under country B's provisions that do not contain a "back link", the payments are tax deductible, the corresponding receipts are not treated as exempt dividends for A Co under country A's tax laws. With regard to country B's rule, it is also irrelevant that the tax exemption of the receipts is, in fact, denied in country A, with country A's corresponding rule countering deduction and non-inclusion schemes as it would be disregarded, as it contains a "back link". As, under country A's provisions that do not contain a "back link", the receipts are exempt, the corresponding payments made under the hybrid instrument are not treated as deductible interest expenses for B Co under country B's tax laws. As both the exemption and the deduction are denied, the result is economic double taxation.

With a tie-breaker test that disregards foreign law insofar as it contains a "back link" instead of double non-taxation, the result could be economic double taxation. It appears that countries are more willing to accept economic double taxation than economic double non-taxation due to a mismatch in treatment. In this respect, it at least appears that countries hesitate to introduce rules, which would allow deduction of non-deductible dividends in circumstances where the corresponding receipts are taxable interest at the level of the recipient, or rules, which would permit the exemption of taxable interest in circumstances where the corresponding payments are non-deductible dividends at the level of the payer.[12] Accordingly, taxpayers would have the choice of either suffering economic double taxation or using, whenever they envisage a risk of economic double

12. *See*, from a Danish perspective, J. Bundgaard, *Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage – The Case of Hybrid Entities and Hybrid Financial Instruments*, 67 Bull. Intl. Taxn. 4/5, sec. 4.2. (2013), Journals IBFD, and, from an Austrian perspective, S. Kirchmayr & G. Kofler, *Beteiligungsertragsbefreiung und Internationale Steuerarbitrage*, 10 Zeitschrift für Gesellschaftsrecht und angrenzendes Steuerrecht 9, p. 452 (2011); M. Stefaner, *Konsequenzen der Anwendung von § 10 Abs. 7 KStG*, 22 Steuer und Wirtschaft International 8, p. 371 (2012); Bendlinger, *supra* n. 1, at p. 488; and Schmidt & Binder, *supra* n.11.

taxation, other financial instruments that are correspondingly treated as equity or debt by both countries.

2.4. Solution (3)

Under solution (3), where both countries provided for rules countering deduction and non-inclusion schemes that considered the tax treatment of the other country, the tie-breaker test could resolve such a conflict by adopting an international meaning of equity and debt. Under such a tie-breaker test, the rule that denied the tax deduction would not apply if the instrument was qualified as debt based on an international meaning. If it was qualified as debt, it would be the responsibility of the recipient's country to counter the deduction and non-inclusion scheme by applying its rule that denied the tax exemption. At the same time, this rule would not apply if the instrument was qualified as equity based on an international meaning. If it was equity, it would be the responsibility of the payer's country to counter the deduction and non-inclusion scheme by applying its rule. Under solution (3), both economic double non-taxation and economic double taxation could be avoided (*see* Example (yet further continued)).

Example (yet further continued)

Country B introduces a rule that denies the tax deductibility of interest expenses, which are exempt at the level of the recipient due to a mismatch in treatment. However, this rule does not apply if: (1) a rule of another country makes taxability dependent on whether or not the interest expenses are deductible in country B; and (2) the financial instrument is qualified as debt based on an international meaning. Country A introduces a rule that denies the tax exemption of dividends, which are deductible at the level of the payer due to a mismatch in treatment. However, this rule does not apply if: (1) a rule of another country makes tax deductibility dependent on whether or not the dividends are tax exempt in country A; and (2) the financial instrument is qualified as equity based on an international meaning. If the financial instrument is qualified as debt under an international meaning, the result is as follows. As both conditions of country B's tie-breaker test are met (country A's rule contains a "back link" and the instrument is qualified as debt), country B's rule countering deduction and non-inclusion schemes does not apply. Consequently, payments made under the hybrid instrument are treated as deductible interest expenses for B Co under country B's tax laws, i.e. the tie is broken. As, at the same time, the conditions of country A's tie-breaker test are not met (the instrument is qualified as debt, not as equity) and the dividends are tax deductible at the level of the payer, country A's rule countering deduction and non-inclusion schemes applies. Consequently, the receipts are not treated as exempt dividends for A Co under country A's tax laws.

In order to effectively counter "circular links" in all situations, it is necessary that both country A and country B introduce a tie-breaker test that follows an international meaning of equity and debt. Only country B's tie-breaker test removes the "circular link" if the instrument is qualified as debt and only country A's tie-breaker test removes the "circular link" if the instrument is qualified as equity.

What could be the basis for an international meaning of equity and debt? As a starting point, articles 10(3), 11(3) and 12(2) of the OECD Model[13] should be taken into account, as these define the terms "dividends" (equity) as well as "interest" and "royalties" (debt). Article 10(3) of the OECD Model has the disadvantage that it partly relies on the tax treatment of the laws of the state of which the company making the distribution is a resident and, at the same time, refers to article 4(1) of the OECD Model, which again partly relies on the tax treatment of the laws of the state to which the company has a certain personal attachment and, in cases of dual residence, again requires a tie-breaker test. In contrast, articles 11(3) and 12(2) of the OECD Model contain definitions of "interest" and "royalties" which do not refer to domestic tax laws.[14] Additionally, the wording of the definitions of "interest payment" in the Savings Directive (2003/48)[15] and of "interest" and "royalties" in the Interest and Royalties Directive (2003/49)[16] are similar to the wording of the definitions of "interest" and "royalties" in the OECD Model.[17] The OECD could recommend that its member countries follow such an international meaning when drafting or revising rules countering deduction and non-inclusion schemes and including a tie-breaker test. Such soft law, although not having legal force, could be persuasive with regard to encouraging governments to change their legislation and could influence the development of legislation in non-OECD economies, as the OECD International VAT/GST Guidelines intend with regard to consumption taxes.[18] Finally, where a tax treaty has been concluded between the countries involved, the tie-breaker test could refer to the definitions of "interest" and "royalties" in that tax treaty. If the tax treaty followed the OECD Model (2010), the widely accepted meanings of equity and debt for treaty purposes would also be used for domestic law purposes to counter "circularly linked" rules, and if the tax treaty deviated from the OECD Model (2010), bilateral definitions of equity and debt would be considered.[19]

13. *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.

14. Only *OECD Draft Tax Convention on Income and on Capital* art. 11(3) (30 July 1963), Models IBFD, refers to "the taxation law of the State in which the income arises". In this context, *see also OECD Draft Tax Convention on Income and on Capital: Commentary on Article 11* para. 25 (30 July 1963), *Models IBFD; OECD Model Tax Convention on Income and on Capital: Commentary on Article 11* para. 19 (1 Apr. 1977), Models IBFD; and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 11* para. 21 (1 Sept. 1992-22 July 2010), Models IBFD.

15. EU Saving Directive: Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ L157 (2003), EU Law IBFD.

16. EU Interest and Royalties Directive: Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L157 (2003), EU Law IBFD.

17. Article 6(1)(a) of the Savings Directive (2003/48) (the definition of "interest payment") is almost identical to *OECD Model Tax Convention on Income and on Capital* art.11(3) (11 Apr. 1977-22 July 2010), Models IBFD. Article 2(a) of the Interest and Royalties Directive (2003/49) (the definition of "interest") is also almost identical to article 11(3) of the *OECD Model* (1977-2010) and only uses the term "income from securities" instead of "income from government securities". Article 2(b) of the Interest and Royalties Directive (2003/49) (the definition of "royalties") resembles article 12(2) of the *OECD Draft* (1963), but not the *OECD Models* (1977-2010), as payments for the use of, or the right to use, industrial, commercial or scientific equipment are also regarded as royalties and "software" is also explicitly included.

18. *See*, for example, A. Charlet, *VAT Focus: Draft OECD VAT/GST Guidelines*, Tax J. p. 22 (22 Mar. 2010) and A. Charlet & S. Buydens, *The OECD's Draft Guidelines on Neutrality for Value Added Taxes*, Tax Notes Intl. p. 447 (2011).

19. *See* C. Marchgraber, *Dividendenbesteuerung und internationale Steuerarbitrage (§ 10 Abs 7 KStG)*, in *Dividenden im Konzern* (M. Lang et al. eds., Linde forthcoming).

3. Conclusions

The OECD Report regards specific and targeted rules that link the tax treatment in one country to the tax treatment in another in appropriate situations as having significant potential to address certain hybrid mismatch arrangements. Linking the tax treatment in one country to the tax treatment in another is not unusual (consider, for example, foreign tax credits, controlled foreign company regimes, subject-to-tax provisions and the recapture of foreign losses)[20] and also appears to be a good solution in countering mismatches and economic double non-taxation. However, if countries continue to introduce different types of rules countering deduction and non-inclusion schemes and cannot agree on a common concept, either denying a deduction of payments that are not included in the taxable income of the recipient or disallowing an exemption of income that is deductible at the level of the payer, the rules will become "circularly linked". In such circumstance, it would be hard to say which of the two rules should have priority, whether both rules apply or both do not apply, or whether the only effective solution is to toss a coin. Consequently, a tie-breaker test is needed. However, a tie-breaker test appears to require an international meaning of equity and debt if countries also intended to effectively counter economic double taxation.

The real cause of hybrid mismatch arrangements and deduction and non-inclusion schemes is the divergent domestic tax laws of countries. Unfortunately, the OECD acknowledges the harmonization of domestic laws as a way to eliminate commonly exploited differences only as a "theoretical approach" that "does not seem possible" and is noted "simply... for the sake of completeness".[21] In addition, with regard to the European Union, where the chances of harmonized approaches countering "aggressive tax planning" appears to be greater, the Commission has recently decided to counter only the symptoms of unharmonized rules.[22] Specifically, the Commission recommends introducing a general anti-abuse rule (GAAR) to counter "artificial arrangement[s]" that have been instituted for the essential purpose of avoiding taxation and that result in a tax benefit. Such artificial arrangements should be ignored and treated for tax purposes by reference to their economic substance.[23] However, it is doubtful as to whether deduction and non-inclusion schemes necessarily constitute "artificial arrangement[s]". According to the Commission, an artificial arrangement "lacks commercial substance".[24] Does the use of a financial instrument lack commercial substance for the sole reason that it is qualified as debt in one country and as equity in another? And even if such an instrument were considered to be "artificial", is the instrument "in reality" equity or debt for the tax purposes of both countries or what is the "reality" if the countries take divergent views on the economic substance of equity and debt?

It appears that the GAAR proposed by the Commission would not accurately counter deduction and non-inclusion schemes and, therefore, the Member States would still envisage the need to introduce specific and targeted rules. However, in countering hybrid mismatch arrangements with such unilateral rules, tax systems would become more complex[25] and new and complex problems could arise. "Circularly linked" rules illustrate this. In order to counter hybrid mismatch arrangements and "circularly linked" rules, coordinated approaches as well as harmonized laws and definitions, though difficult to establish, remain the best solution.

20. Bendlinger, *supra* n. 1, at p. 490.
21. OECD Report, *supra* n. 1, at para. 30.
22. European Commission, Commission Recommendation on aggressive tax planning, C(2012) 8806 final (6 Dec. 2012). *See also* M. Lang, *"Aggressive Steuerplanung" – Eine Analyse der Empfehlung der Europäischen Kommission*, 23 Steuer und Wirtschaft International 2, p. 62 (2013).
23. European Commission Recommendation, *supra* n. 22, at p. 4, m.no. 4.2.
24. Id., at p. 4, m.no. 4.4.
25. Postma & Nouwen, *supra* n. 1, at p. 38.