OECD vs. D/NI: Ending Mismatches on Hybrid Instruments, Part 1

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In July 2013 the OECD issued the action plan for its base erosion and profit-shifting project.1 The action plan was endorsed by the G-20 heads of government2 in September 2013.

The action plan identifies 15 items, including action 2 on neutralizing the effects of hybrid mismatch arrangements.3 The action plan states that the work on action 2 is intended to be completed by September 2014.4 Accordingly, on March 19, 2014, the OECD released for public comments5 a discussion draft consisting of proposed recommendations to implement action 2.6 The discussion draft deals with hybrid instruments, hybrid entities, and other structures that give rise to duplicative tax benefits in two or more jurisdictions.7 An accompanying discussion draft addresses tax treaty issues arising from hybrids.8

The deadline for comments on both discussion drafts was May 2—an extremely short comment period for proposals of this magnitude. Seventy comment letters, totaling more than 450 pages, were received and

2The G-20, in contrast to the OECD, includes countries such as China, India, Russia, and Brazil.
3OECD action plan, supra note 1, at 15-16. The full text of action 2 is as follows:

Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.
4Id. at 30.
7For an earlier version of the discussion draft, see OECD, “Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues” (Mar. 2012).
made public.9 An all-day public consultation was held May 15.10 The OECD Committee on Fiscal Affairs is expected to present the proposals to the G-20 finance ministers for approval at their September 20-21 meeting in Australia. The G-20 leaders are then expected to consider the final recommendations at their November 15-16 summit meeting in Australia.

After providing background, this report discusses the portion of the discussion draft concerning hybrid instruments.11 I use the following terminology:

Payments on an instrument are made by a payer (the “payer” or the “payer corporation”) located in the “payer jurisdiction.” Payments on an instrument are received by a payee (the “payee” or the “payee corporation”) located in the “payee jurisdiction.” In some cases, the payee is owned by a shareholder (the “shareholder”) located in the “shareholder jurisdiction.”

I. Background

A. U.S. Common Law

Historically, the U.S. tax law has not been concerned about whether the foreign tax characterization of an arrangement is the same as the U.S. tax characterization and, if not, whether that inconsistency might result in duplicative tax benefits. For example, it has long been clear that a U.S. person entering into a nominal lease of property is considered the U.S. tax owner of the property if the terms of the lease give it sufficient economic indicia of ownership, even if the non-U.S. lessor of the property is considered the tax owner in its local jurisdiction.12

Likewise, a recent case upheld a taxpayer’s intentional structuring of an instrument as equity for U.S. tax purposes and debt for Dutch tax purposes. The result was an interest deduction in the Netherlands and a tax-free return of capital in the United States.13 The court referred to the intentional structuring as “legitimate tax planning” and to the instrument as a “legitimate hybrid instrument.”14 In fact, the treatment of an instrument under foreign law is not even on the list of factors regularly considered by a court in determining the nature of an instrument as debt or equity.15

The IRS has also had mixed success in attacking so-called structured trust advantaged repackaged securities (STARS) transactions, which were hybrid arrangements designed to obtain double tax benefits. While the details varied, in general, a U.S. corporation wanting to borrow money from a U.K. bank would transfer a large amount of investment assets to a U.K. trust and borrow money from the bank by way of a repo transaction on the equity in the trust. The earnings of the trust were subject to U.K. tax.

Both the U.S. corporation and the U.K. bank were treated as the owner of the trust for tax purposes in their respective jurisdictions. The U.S. corporation claimed a foreign tax credit for the U.K. tax paid by the trust, and the U.K. bank claimed U.K. tax benefits from its ownership of the trust. The U.K. bank rebated a portion of its tax benefits to the U.S. borrower through a reduction in the interest rate paid by the borrower on the loan (by way of a reduction in the repurchase price under the repo).

The IRS challenged the FTC claims by U.S. borrowers on the ground that the transaction had no economic substance. So far, the government has had mixed results at the trial court level.16 However, the government’s primary argument against the transaction has been the economic substance doctrine. If the transaction satisfies the economic substance doctrine and meets the other statutory and nonstatutory requirements of U.S. tax law, the taxpayer will be entitled to tax benefits regardless of duplicative benefits in another jurisdiction.

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9OECD, “Comments Received on Public Discussion Drafts BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements” (May 7, 2014).
10The two videos of the meeting can be found at “WP11 — Public Consultation on Hybrids” (May 15, 2014), available at http://video.oecd.org/?action=video&id=1133.
11This report does not discuss the portion of the discussion draft that concerns hybrid entities. It also does not discuss the discussion draft on tax treaties, which relates primarily to hybrid entities.
12TAM 9748005 and TAM 9802002. (“This dual tax ownership will not be a concern in the United States when it is solely the result of differing U.S. and foreign legal standards of tax ownership being applied to the same facts because tax ownership is determined under U.S. legal standards without regard to the tax ownership treatment obtained under foreign law. Thus, the United States need not be concerned where the taxpayer in a cross-border transaction is able to show that the same facts that led the foreign taxing authorities to conclude that ownership lies in the foreign party, also support the conclusion that the taxpayer is the owner under U.S. standards.”).
14Id.
15Id.
16Compare Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15 (2013), T.C. Memo. 2013-225 (taxpayer loses; no economic substance to transfer of assets to the foreign trust, the only purpose of which was to generate FTCs); and Salem Financial Inc. v. United States, 112 Fed. Cl. 543 (2013) (same); with Santander Holdings USA Inc. v. United States, 977 F. Supp. 2d 46 (D. Mass. 2013) (taxpayer wins; it did pay the foreign taxes, and the overall transaction was a true borrowing with economic substance). See also Am. Int’l Group v. United States, 09 Civ. 1871 (S.D.N.Y. 2013) (denial of summary judgment to taxpayer; interlocutory appeal to Second Circuit pending); Wells Fargo & Co. v. United States, D.Minn. July 21, 2014 (Report of Special Master) 09-cv-02764 (denial of summary judgment to taxpayer on business purpose issue).
B. U.S. Legislation

In specific situations, U.S. legislation prevents tax benefits from being claimed in more than one jurisdiction from the use of hybrid instruments or hybrid entities. Section 1503(d), enacted in 1986, restricts the use of dual consolidated losses that often arise from hybrid entities. Section 894(c), enacted in 1997, restricts the benefits of hybrid entities under tax treaties.17

Efforts against hybrids received a setback in 1998. After the adoption of the check-the-box regulations in 1997, the IRS and Treasury tried to limit the use of checked entities to both reduce foreign tax and avoid subpart F.18 The agencies were forced to back down19 by the imminent threat of a congressional moratorium on further action.20

Two provisions enacted in 2010 were aimed in part at hybrid instruments and entities. First, section 909 limits the use of FTCs when the foreign tax, but not the underlying income, is taken into account in the United States. As will be illustrated in Part III.B.5.j.iii, hybrid instruments can be used to create that result.21 Section 909(e)(2) specifically authorizes regulations to determine the application of the section to hybrid instruments, and those regulations have been issued.22

Second, section 901(m) deals with an international mismatch that can arise from a hybrid entity. Assume a foreign corporation is treated as a corporation for local tax purposes but is a disregarded entity for U.S. purposes. A purchase of the corporation’s stock is treated as a stock purchase (with a carryover asset basis) for foreign tax purposes but as an asset purchase (with a stepped-up asset basis) for U.S. tax purposes. The target corporation then has a lower tax basis in its assets, and thus more taxable income, for foreign than for U.S. tax purposes. The section denies an FTC for foreign tax paid on this additional foreign income that does not exist for U.S. tax purposes.

Additional legislation concerning hybrids has been proposed recently. The “Baucus bill”23 would disallow a deduction for any payment to a related party (tested under a 50 percent vote or value test) arising in connection with a base erosion arrangement. A base erosion arrangement is any transaction that reduces the amount of foreign income tax as a result of a hybrid transaction, instrument, or entity; or an exemption arrangement (that is, one that reduces the generally applicable tax on income by 30 percent or more) or conduit financing arrangement.

The Obama administration’s fiscal 2015 budget proposal also contains a provision on hybrids. No deduction would be allowed for interest or royalty payments to a related party if, as a result of a hybrid arrangement, either there is no corresponding inclusion in a foreign jurisdiction or the taxpayer can claim another deduction for the same payment in another jurisdiction. Further, regulations could deny deductions for interest or royalty payments under a hybrid arrangement (1) when a conduit arrangement exists, (2) when the payments are made to an unrelated party and a structured transaction is involved, or (3) when the recipient jurisdiction taxes the income under a preferential regime that reduces the generally applicable rate by at least 25 percent.24

C. Non-U.S. Legislation

The EU and foreign jurisdictions have also been active in attacking hybrids.25 For example, the EU parent-subsidiary directive now requires that dividends from a subsidiary in a member state to a parent in a member state be exempt from tax in the parent’s jurisdiction. On July 8, the EU Council adopted an amendment (the EU amendment) to the directive that requires the parent jurisdiction to tax the dividend if it is deductible by the subsidiary. Member states are required to incorporate the amendment into local law by the end of 2015.26 The existing exemption for deductible dividends had previously been referred to as a “tax loophole” that “allows corporate groups to exploit mismatches between national tax rules so as to avoid paying taxes on some types of profits distributed within the group.”27

17 See reg. section 1.894-1(d).
21 See the example in JCT, “General Explanation of Tax Legislation Enacted in the 111th Congress,” JCS-2-11, at 430 (Mar. 24, 2011).
25 See Lee A. Sheppard, “Countries Implement BEPS on Their Own,” Tax Notes Int’l, May 26, 2014, p. 692. This article reports that anti-hybrid legislation has been adopted or is being considered by Denmark, South Africa, Italy, the United Kingdom, Germany, Hungary, Poland, Australia, Spain, Mexico, France, and Austria, and that other countries have invoked general antiabuse rules to attack hybrid transactions. See also JCT, “Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises,” JCX-90-14, at 58 (July 21, 2014), describing anti-hybrid legislation in Austria, France, Germany, and Mexico.
26 EU Council press release, “Council Adopts Amendment Closing Tax Loophole for Corporate Groups,” 116/47/14 (July 8, 2014). The text of the amendment is contained in EU Council,

(Footnote continued on next page.)
As another example, under the French Finance Act of 2014, interest on a loan to a resident of France from a related party (resident or nonresident in France) is not deductible in France if the interest income is subject to tax at a rate of less than 25 percent of the usual French rate. This legislation was originally directed at hybrid instruments but now applies to any instrument on which the income is taxed at a sufficiently low rate. Draft regulations provide that the French payer has the burden of proof to show that the income is subject to the necessary level of tax in the payee jurisdiction.28

II. Policy Issues

Anti-hybrid proposals are generally justified on the basis that hybrids result in income that is not taxed anywhere (so-called stateless income). However, stateless income usually refers more broadly to any income that has been shifted to a low-tax or no-tax jurisdiction. In that sense, stateless income would arise any time the payee on a straight debt instrument (not a hybrid) was in a no-tax jurisdiction and the payer was deducting interest in a high-tax jurisdiction. However, this problem has nothing to do with the hybrid nature of the instrument. Proposed solutions to this problem involve limitations on interest deductions generally, the expansion of controlled foreign corporation regimes, and the imposition of withholding tax on interest.

The problem arising from hybrids is both narrower and more complex as a conceptual matter. The payee on a debt instrument would normally be taxed at ordinary income rates on interest income in the payee jurisdiction to match the ordinary deduction for interest in the payer jurisdiction. However, if the payee jurisdiction characterizes the instrument as equity, the payee jurisdiction may treat the receipt as tax-favored dividend income. Because of the different characterizations by the two jurisdictions, total global tax revenue has been reduced as compared with the cases in which both jurisdictions treat the instrument as debt or both jurisdictions treat the instrument as equity.

Hybrids raise several fundamental conceptual questions that are not easily answered. First, it is unclear whether either the payer jurisdiction or the payee jurisdiction is unjustifiably losing any tax revenue, given that its own tax rules are fully complied with. For example, it is unclear why the payer jurisdiction should be considered to be unjustifiably losing tax revenue on account of an interest deduction in its jurisdiction merely because the payee is not taxed on the corresponding income in the payee jurisdiction.

Second, if the payer jurisdiction is considered to have an unjustifiable loss of revenue, it is unclear why the loss is more objectionable because of the recharacterization of the instrument as equity in the payee jurisdiction than it would be if the payee jurisdiction was a tax haven that did not recharacterize the instrument but had no income tax in the first place. Third, if the hybrid nature of the instrument is considered to result in an unjustifiable loss of tax revenue when both the payer and payee jurisdictions have an income tax, it is unclear whether the loss is to the payer jurisdiction because of the interest deduction or to the payee jurisdiction because of the favorable dividend treatment.

There are no good answers to these questions. Yet taxpayers are using hybrid instruments and entities to create large amounts of income that is not taxed anywhere. Overall worldwide tax revenue is clearly a concern, and the problem is likely to get worse before it gets better in the absence of restrictive legislation. The problem is exacerbated by the fact that the payer and payee on a hybrid instrument do not have adverse interests, since both can gain when the overall tax liability is reduced.

However, the loss of global tax revenue from hybrid instruments and entities should be kept in perspective. The loss is likely far less than the revenue lost from the shifting of non-hybrid income to low-tax jurisdictions. Actions taken by governments solely against hybrids will not even come close to solving the problem of stateless income. In fact, actions taken against hybrids alone will merely shift the focus of tax planning to the creation of international mismatches that do not involve hybrids. Actions against hybrids can be effective only if accompanied by other actions such as those contemplated by the BEPS project.

III. The Discussion Draft

A. Background

The discussion draft contains numbered paragraphs. References herein to these paragraphs are in the form of “(x)” so that, for example, “(5)” refers to paragraph 5 of the discussion draft.

The discussion draft defines a hybrid mismatch arrangement as “a profit shifting arrangement that utilises a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement” (17). The arrangement must “rely on a hybrid element” to produce the mismatch (23).

The discussion draft provides a detailed and comprehensive set of rules for countries to adopt to deal with mismatches that arise from hybrid instruments and hybrid entities. In the context of hybrid instruments, the purpose is to eliminate what is called “D/NI.” This is

“Legislative Acts and Other Instruments,” 10996/14 (June 27, 2014). An interpretation of the amendment is contained in EU Council, “I/A” Item Note 11291/14 ADD 1 (June 27, 2014). The amendment and the interpretation are discussed in Part III.B.5(1) below.


“deduction, no inclusion” — namely, a deduction in one jurisdiction without an offsetting ordinary income inclusion in another jurisdiction (20). The discussion draft makes no attempt to determine which country has a theoretical loss of tax revenues (28). Rather, its rules simply determine which jurisdiction gains tax revenues from the elimination of D/NI.

B. Payments on Hybrid Instruments

1. How D/NI Arises

D/NI arises when a payment on a financial instrument is deducted in the payer jurisdiction by the payer but not included in the ordinary income of the payee under the laws of the payee jurisdiction (83). It arises even if the payment is included in the income of the payee, if the resulting income is taxed by the payee jurisdiction at a rate below the rate for ordinary income or if it is entitled to other tax relief compared with other ordinary income (62).

The most typical case of D/NI arises when an instrument is treated as debt in the payer jurisdiction and equity in the payee jurisdiction, with interest payments deductible in the payer jurisdiction and dividends subject to a favorable tax regime in the payee jurisdiction (a debt/equity hybrid).

However, D/NI can arise even on an instrument treated as debt in both the payer and payee jurisdictions when particular payments on the instrument are characterized differently in the two jurisdictions (a debt/debt hybrid). For example, D/NI would arise from any of the following:

a. a debt instrument with original issue discount, when the OID is an ordinary deduction in the payer jurisdiction and taxed at a favorable rate in the payee jurisdiction;

b. a zero- or low-interest loan, or a note for a deferred purchase price of an asset, when the payer jurisdiction allows an imputed interest deduction at a specified rate, and the payee jurisdiction requires either no corresponding ordinary income inclusion or an inclusion at a lower imputed interest rate than the payer jurisdiction’s rate; and

c. convertible debt when the payer jurisdiction allows an imputed interest deduction based on bifurcating the debt into discount debt and a warrant but the payee jurisdiction does not impute interest income for that amount (64, 90).

While not specifically mentioned in the discussion draft, the logic of the above examples indicates that D/NI would also arise when an issuer redeems a debt instrument at a premium, if the premium is deductible by the issuer and is taxed at a favorable rate in the payee jurisdiction.

2. Consequences of D/NI

If D/NI exists, rules referred to herein as the “anti-D/NI rules” apply. The following anti-D/NI rules are to be applied in sequence. The application of the sequence stops with any particular rule if, after applying that rule, D/NI no longer exists.

Rule 1: If the payment is viewed as a dividend in the payee jurisdiction and the payee jurisdiction provides a tax exemption for dividend income, such as a participation exemption, the payee jurisdiction should not allow that exemption to apply to payments deductible by the payer (84). This is similar to the EU amendment discussed in Part I.C. above. The application of rule 1 would normally eliminate D/NI.

Note that rule 1 does not apply if the payee jurisdiction merely imposes a reduced tax rate on dividend income, such as the reduced U.S. rate for dividends from a qualified foreign corporation. As a result, rule 1 would not require the United States to tax those dividends as ordinary income.

Rule 2: If there is D/NI after considering rule 1, the payer jurisdiction should not allow a deduction for a payment to the extent that the payment is not included in the ordinary income of the payee (83(a)).

Rule 3: If there is D/NI after taking into account rule 1 and rule 2 (for example, rule 1 does not apply, the payer jurisdiction did not adopt rule 2, and the payee jurisdiction taxes the income at a favorable rate), the payee jurisdiction should tax the payment as ordinary income to the extent it is deductible in the payer jurisdiction (83(b)).

Rule 3, unlike rule 1, would override the U.S. rules for dividends from a qualified foreign corporation. For example, suppose a U.S. holder holds perpetual debt issued by a non-U.S. payer, and the payer jurisdiction does not adopt rule 2 and continues to allow a deduction for interest on that debt. Rule 3 would require the United States to tax the dividend at ordinary income rates.

3. Operating Rules

a. D/NI does not arise simply because the general tax rates on ordinary income in the payer and payee jurisdictions are different. There is no D/NI even if the deduction in the payer jurisdiction is at a rate of, say, 40 percent, but the income inclusion in the payee jurisdiction is at the regular rate of, say, 5 percent on ordinary income.

b. There is no D/NI if the payee jurisdiction does not have an income tax. In this case, there is no tax relief in the payee jurisdiction on account of the instrument being a hybrid or payments on the instrument being characterized in a tax-favorable way (94, 97-99). In fact, it is not even meaningful to ask whether a payee jurisdiction without an income tax would characterize an instrument differently than the payer jurisdiction. Moreover, absent this rule, every debt instrument held by a

29Section 1(b)(11).
payee in a no-tax jurisdiction would be a debt/debt hybrid, and rule 2 would disallow an interest deduction to the payer. This is clearly not the intent of the discussion draft.

c. There is no D/NI if the payer jurisdiction does not have an income tax. In that case, there is no deductible payment in the payer jurisdiction, and there cannot be D/NI without a deductible payment.

d. The test for D/NI is based on how each jurisdiction would tax a normal taxpaying entity making or receiving the payment (97, 98, 107). For example, there is no D/NI solely because the particular payee is a tax-exempt charity in its local jurisdiction. Likewise, there is deemed to be a deduction in the payer jurisdiction if the payment is generally of the type deductible in the payer jurisdiction. As a result, D/NI can arise even if the particular payer cannot deduct the payment, for example, under the local thin capitalization rules (241).

e. There is no D/NI solely on account of timing differences between the deduction in the payer jurisdiction and the income inclusion in the payee jurisdiction (26, 88).

f. The no-inclusion component of D/NI arises “to the extent” that the payment is not included in ordinary income in the payee jurisdiction (83(a), 103). If the payee jurisdiction treats only a portion of the payment as exempt from tax or taxable at a below-ordinary rate, the anti-D/NI rules apply only to that portion of the payment (108(a)).

g. The anti-D/NI rules do not require the payer or payee jurisdiction to change the nature of the instrument or the payment for general tax purposes (38). Rather, the only required change is whether a payment is includable in income or deductible.

h. CFC rules are disregarded in determining whether there is D/NI (36).

i. Even if the payee jurisdiction taxes a dividend at ordinary income rates, D/NI arises if the dividend is eligible for a collateral benefit such as an indirect FTC (62, 108).

4. Summary Chart

The effects of the anti-D/NI rules in different situations are summarized in the table on the following page. In the table:

- “D” stands for “deductible” or “deduction.”
- “ND” stands for “no deduction” or “not deductible.”
- “NI” stands for “no inclusion.”
- “OI” stands for “ordinary income.”
- “RTR” stands for “reduced tax rate.”

Each cell in the table first gives the result to the payer, then the result to the payee.

5. Observations and Issues

a. Debt/equity hybrids. The typical hybrid instrument subject to the anti-D/NI rules is a debt/equity hybrid in which the payee jurisdiction taxes dividends at a favorable rate. Typically, these instruments are intentionally designed to be debt/equity hybrids, although accidental hybrids are also possible. If the anti-D/NI rules are adopted, the number of intentional debt/equity hybrids is likely to decrease, but accidental hybrids will continue to exist.

Surprisingly, a debt/equity hybrid can result in D/NI even if the payee jurisdiction taxes dividends at regular ordinary income tax rates. In that case, D/NI would arise if the payer corporation has no earnings and profits, and the payee jurisdiction does not tax distributions that exceed E&P. In that case, rule 2 would disallow an interest deduction to the payer corporation, and rule 3 would require the payee jurisdiction to tax,
at ordinary income rates, what it considers to be a return of capital distribution to the payee.30

b. Debt/debt hybrids. As noted in Part III.B.1, D/NI can also arise on a debt/debt hybrid. In fact, the discussion draft goes as far as saying that it expects rule 1 to eliminate most mismatches from debt/equity hybrids and that the “primary targets” of rules 2 and 3 are structured debt/debt hybrids in which the mismatch arises from “technical differences” in the way that the payer and payee jurisdictions tax debt instruments (116).

It is critical to note that a debt instrument of any kind is a debt/debt hybrid subject to the anti-D/NI rules if any payment on the debt is deductible in the payer jurisdiction and subject to favorable tax rates in the payee jurisdiction. Moreover, because the term “payment” includes accruals (86), a debt/debt hybrid arises if any accrual of a deduction by the payer is not matched at some point by an ordinary income inclusion by the payee.

The applicability of the anti-D/NI rules to debt/debt hybrids greatly expands the universe of payments that potentially give rise to D/NI. As a result, it also greatly expands the level of knowledge that the payer, payee, and tax authorities in both jurisdictions will need to determine whether the anti-D/NI rules apply. It is one thing to need an understanding about whether another jurisdiction is likely to treat a particular instrument as debt or equity. It is quite another to need to know exactly how another jurisdiction treats every payment or accrual on the instrument.

For example, a payer in a rule 2 jurisdiction that issued debt with contingent payments would need to fully understand any rules in the payee jurisdiction similar to the U.S. rules for contingent payment debt obligations, treating gains on redemption of the debt as ordinary income.31 A payee in a rule 3 jurisdiction that held convertible debt redeemed at a premium would need to know if the payer jurisdiction had a rule like section 249, disallowing a deduction for the premium to the extent attributable to the conversion feature.

Moreover, even if the laws of every jurisdiction are known, the results can be quite surprising. Suppose the payer and payee enter into a no-interest loan, the payer jurisdiction imputes interest deductions at a LIBOR-based rate, and the payee jurisdiction imputes interest income at a rate based on the applicable federal rate. The excess of the former rate over the latter is D/NI, and that amount (if any) may vary in each period. In fact, in some periods there might be more payee income inclusions than payer deductions, and it is unclear how (if at all) that “negative D/NI” would be available to offset positive D/NI in other periods.

Next, suppose there is an imputed interest deduction on a debt/debt hybrid in the payer jurisdiction without any corresponding imputed interest income in the payee jurisdiction. Even if the payee jurisdiction taxes interest at ordinary income rates, D/NI would exist and rule 2 would disallow the payer deduction. The reason is that the payee jurisdiction’s failure to impute interest income has resulted in a tax reduction in the payee jurisdiction. Note that even a 1 percent tax rate on all income in the payee jurisdiction would result in D/NI and cause the entire imputed interest deduction to the payer to be disallowed, while a 0 percent tax on all income in the payee jurisdiction would (as always) permit the entire imputed interest deduction to be allowed.

Finally, the application of the anti-D/NI rules to the redemption premium on debt is quite anomalous in a jurisdiction such as the United States where the premium is deductible to the issuer-payer32 and is capital gain to the holder-payee.33 A U.S. payer redeeming debt at a premium could deduct the premium paid to all U.S. payees, but rule 2 would disallow the deduction on payments to non-U.S. payees that received the same tax benefits locally that are allowed to all U.S. payees. Likewise, a U.S. payee receiving a redemption premium from a non-U.S. payer would lose capital gain benefits under rule 3 if the payer could deduct the premium locally, even though the U.S. payee would retain its capital gain benefits by receiving premium on a bond with a U.S. payer that could deduct the premium.

c. Effect on total tax revenue is irrelevant. The discussion draft states that the hybrid mismatch arrangements targeted by the rules are those “where the resulting mismatch results in a lower aggregate tax burden for the parties to the arrangement” (17). Elsewhere, the discussion draft refers to “any hybrid arrangement that has the effect of lowering the overall global tax rate of parties affected by the arrangement” (32).

However, this language cannot be taken literally. The anti-D/NI rules apply or do not apply completely without regard to whether the deduction and inclusion of any particular payment would, absent the rules, result in a loss of worldwide revenue or even an increase in worldwide revenue.

For example, when the payee jurisdiction imposes no income tax, there is a worldwide loss of tax revenues from the interest deduction in the payer jurisdiction. However, because the loss does not arise from the hybrid nature of the instrument, the anti-D/NI rules do not apply.

30 See Part III.B.5.g.i, discussing a possible exception to this rule if the payee jurisdiction taxes gains on the sale of the stock at ordinary income rates.
31 Reg. section 1.1275-4(b)(8).
32 Reg. section 1.163-3(c)(1).
33 Section 1271(a)(1).
Alternatively, assume that the payer deducts a payment at a rate of 15 percent, the payee jurisdiction has an ordinary income tax rate of 35 percent, and the payee jurisdiction taxes payments on the instrument at the favorable rate of 20 percent because of the hybrid nature of the instrument. There is an overall increase in tax revenue because the payment is deducted at 15 percent and included in income at 20 percent. Nevertheless, rule 2 would disallow at least a portion of the deduction because the worldwide tax is less than if the payee jurisdiction taxed the income at 35 percent.

d. Relationship to other OECD proposals. Action 2 states that its work will be coordinated with the work on interest expense deduction limitations, the CFC rules, and treaty shopping. The first reference is to action 4 of the BEPS project, titled “Limit base erosion via interest deductions and other financial payments.” Action 4 will presumably deal with overall loss of tax revenues, whether or not through the use of hybrid instruments. This reduces the need for action 2 to focus on overall tax revenues.

At a minimum, however, the anti-D/NI rules will need to be evaluated in the context of recommendations proposed under action 4. The more restrictive the rules under action 4, the less the need for strict and complex anti-D/NI rules. However, if action 4 does not place strict limits on interest deductions generally, it may not be worthwhile to impose the anti-D/NI rules under action 2. As discussed in Part II, the worldwide revenue loss from “regular” interest deductions is likely far larger than the revenue loss from hybrid mismatches. If the world community is unwilling to significantly limit the former, it hardly makes sense to impose strict and complex rules to limit the latter.

Unfortunately, work on action 2 is scheduled to be completed in September 2014, but work on action 4 concerning interest deductions is not scheduled to be completed until September 2015. If this schedule is followed, proposals for hybrid mismatches will be adopted with no knowledge of the proposals for overall limits on interest deductions. This will make it difficult to determine how the former rules will work after adoption of the overall limits.

Fortunately, OECD Working Party 11, “Aggressive Tax Planning,” is involved in both action 2 (9, 19) and action 4. It is hoped that this will result in coordination between the proposals as contemplated by action 2. This would require a review of the action 2 proposals after the completion of action 4 to ensure that the overall system makes sense.

e. Payers and payees.

i. Payee vs. payer jurisdictions. Rules 1 through 3 create an intricate level of revenue sharing between payee and payer jurisdictions, as can be seen in the table. Assume the payee jurisdiction has a reduced tax rate on the hybrid income. When rule 1 applies to a hybrid instrument, the payee jurisdiction has the increase in tax revenue. When rule 2 does not apply, or if the payee jurisdiction does not choose to enact rule 1, the payer jurisdiction has the increase in tax revenue if it has enacted rule 2. If the payer jurisdiction does not enact rule 2, the payee jurisdiction has the increase in tax revenue if it has enacted rule 3.

These results can also be seen from a different perspective in the table. If the payer jurisdiction adopts rule 2, cell 13 is replaced by cell 18, and cell 15 is replaced by cell 20. There is no effect in the payer jurisdiction if the payee jurisdiction has adopted rule 1, but the deduction is disallowed if the payee jurisdiction has not adopted rule 1. Likewise, if the payee jurisdiction adopts rules 1 and 3, cell 13 is replaced by cells 14 and 15, and cell 18 is replaced by cells 19 and 20. As a result, the reduced tax rate in the payee jurisdiction is eliminated if rule 1 applies or (as a result of rule 3) if the payer jurisdiction has not adopted rule 2.

This is unusual as a conceptual matter. If one jurisdiction is willing to subsidize the hybrid mismatches of its own residents by not enacting the anti-D/NI rules, other jurisdictions have the opportunity to raise their own revenues at the cost of residents of the first jurisdiction. The enactment of anti-D/NI rules by the other jurisdictions takes away the benefit of hybrid mismatches entered into by residents of the first jurisdiction.

This result is similar to the result that arises from a lack of tax sparing under tax treaties. In the absence of tax sparing, a tax cut in the source country creates reduced FTCs and thus additional tax in the residence country. The source country providing the tax cut is therefore simply shifting tax revenues to the residence country without helping local taxpayers.

In fact, any particular jurisdiction considering adoption of the anti-D/NI rules faces a decision similar to the prisoner’s dilemma in game theory. If it is assumed that most other jurisdictions will adopt the anti-D/NI rules, it is in the economic interest of any particular jurisdiction to do so also. Failure of the particular jurisdiction to do so will not usually reduce the total direct and indirect tax burden borne by its own residents; it will merely shift tax receipts from the particular jurisdiction to other jurisdictions whose residents enter into hybrids with residents of the first jurisdiction. Despite

34OECD action plan, supra note 1, at 17.
35ld. at 31.
37Compare cell 13 with cell 14, and cell 18 with cell 19.
38Compare cell 13 with cell 18.
39Compare cell 13 with cell 15.
the “tax cut” in the first jurisdiction from not adopting the rules, no corporation will gain any economic benefit from locating in the jurisdiction, and the only result will be a loss of tax revenue in the jurisdiction.

However, if it is assumed that many other jurisdictions will not adopt the anti-D/NI rules, there could be a competitive advantage to a particular high-tax jurisdiction in also not adopting those rules. Failure to adopt them would then attract corporations to locate in the jurisdiction so that they could save taxes by entering into hybrid arrangements with residents of the other non-adopting jurisdictions.

ii. Ignore tax character of payee or payer. Rule 2 denies a deduction to the payer if the income of the payee is eligible for any relief “applicable to particular categories of payments” (94). Thus, rule 2 applies whenever the nature of the payment causes it to not be ordinary income in the payee jurisdiction.

As long as the payment is treated as ordinary income in the payee jurisdiction, rule 2 does not apply regardless of whether the particular payee actually pays tax on the income. For example, it is irrelevant that the particular payee is tax exempt in the payee jurisdiction, since tax exemption is “attributable to a particular characteristic of the taxpayer, rather than a particular category of payment” (94, 100). Likewise, it is irrelevant that the payee is not taxed on the income because it has net operating losses (95).

Similarly, rule 2 does apply if the income is not normally subject to tax at ordinary income rates in the payee jurisdiction, even if a particular payee cannot take advantage of the favorable tax treatment. Again, it is irrelevant that the payee may not obtain the benefit of the favorable treatment because it is tax exempt, has NOLs, or loses favorable tax treatment of dividend income because of a rule such as section 246(c) or 246A (95). As another example, rule 2 would apply to a debt/debt hybrid issued with OID if the payee jurisdiction treats OID as tax-favored capital gain, even if the payee purchased the instrument on the market for its face amount. In all these cases, it is irrelevant that (i) the payee is not saving any taxes as a result of the hybrid nature of the instrument, and (ii) rule 1 or rule 3 would not increase the payee’s tax liability.

The same principles apply to the applicability of rules 1 and 3. Those rules deny tax benefits to the payee if the payer is entitled to a deduction for its payments, regardless of whether a particular payer can use the deduction. Thus, it is irrelevant that (i) the payer might be subject to thin capitalization limits on deductions such as section 163(j);40 (ii) the payer is tax exempt (93, 102); (iii) the parties are not saving any over-all taxes as a result of the hybrid nature of the instrument; or (iv) if the payer jurisdiction had adopted rule 2, that rule would have no effect on the payer (because it has no deduction in any event) (102).

These rules provide great simplification. It would be extremely complicated, if not impossible, for the payer or payee to look to the other party’s actual tax situation in determining whether the anti-D/NI rules apply to itself. It is difficult enough to determine the tax law of the other jurisdiction, without having to determine whether a particular payer or payee is actually receiving a tax benefit from the making or receipt of a payment. Moreover, if actual tax benefits were required, complex rules would be needed to determine questions such as whether a payer or payee with operating losses was getting a tax benefit as a result of the hybrid nature of the instrument.

Of course, the resulting simplifying assumptions are made at the cost of precision. As shown in the above examples, the payer or payee can suffer adverse tax consequences even when there is no tax benefit resulting from the hybrid nature of the instrument.

iii. ‘Ordinary status’ payees and payers. Rule 2 applies if the tax benefit to the payee from receipt of the payment would arise if the payee was a taxpayer of ordinary status in its jurisdiction (97). What is ordinary status? We know that tax-exempts are not of ordinary status. But suppose the payee jurisdiction taxes corporations on dividends at a rate below the ordinary income rate, and taxes individuals on dividends at ordinary income rates. That was once the tax regime in the United States. The discussion draft does not mention this fact pattern.

If the taxpayer of ordinary status is a corporate taxpayer, rule 2 would always disallow a portion of the payer’s deduction even if the payee was an individual receiving no tax benefits. If the taxpayer of ordinary status is an individual, rule 2 would never disallow any part of the payer deduction even if the payee was a corporation receiving favorable tax treatment. Neither of those results makes sense.

If both an individual and a corporation are of ordinary status, rule 2 disallows part of the deduction when the payee is a corporation but not when the payee is an individual. This result is more justifiable. However, the applicability of rule 2 then depends not only on the jurisdiction of the payee but also on the tax status of the payee in its jurisdiction. This undercuts the general rule that the particular tax status of the payee is irrelevant and would considerably increase the obligations imposed on the payer in determining the applicability of rule 2.

40The interaction of the disallowance provisions is unclear. Suppose the payer pays $200 of interest, of which $50 is nondeductible because of excess leverage and $25 is nondeductible under rule 2. If the $25 disallowance comes first, only another $25 would be disallowed as overleverage. Alternatively, the $25 disallowed under rule 2 could be considered to come pro rata out of the otherwise “good” deduction of $150 and the “bad” deduction of $50, so the total disallowed deduction would exceed $50.
The same issue arises under rules 1 and 3. Those rules apply if the payment is deductible in the payer jurisdiction without regard to "the specific details of the taxpayer's net income calculation" (93). A tax-exempt payer is treated as just another payer that cannot use the benefit of a deduction (93).

But suppose the payer is an individual and the payer jurisdiction (like the United States) allows the deduction of business interest, some investment interest, and no personal interest. Although a debt/equity hybrid could not have an individual payer, a debt/debt hybrid clearly could.

Rule 3 would in any event cause a loss of tax benefits to the payee if the payer's interest deduction was for business interest or investment interest. However, it is unclear if rule 3 would apply if the payer's interest was nondeductible personal interest. It would be quite unfair to apply rule 3 to the payee in this situation. However, excluding this situation from rule 3 would require the payee to determine the nature of the payer's interest expense. Again, this would be a considerable expansion of the payee's duty of investigation.

iv. Transfers of instruments. The discussion draft acknowledges the difficulty of applying the anti-D/NI rules to instruments that trade frequently (153-157). Disregarding for now a possible exception for widely held instruments, discussed in Part III.D.4, rule 2 requires an ongoing tracking of the payee of an instrument.

At a minimum, a payer subject to rule 2 would have no control over the location of holders and therefore of its deductions. For example, an issuer of a debt/equity hybrid subject to rule 2 would be required to determine on each interest payment date which of the current holders were in jurisdictions that would not tax the payment as ordinary income.

The required factual determinations would be even more difficult for debt with OID or with an imputed interest deduction in the payer jurisdiction. Since OID and imputed interest are deducted daily, a payer subject to rule 2 would theoretically be required to track the jurisdiction of the payees daily to determine whether its daily accrual of deductions was allowed.

The discussion draft suggests the possibility that rule 2 could be simplified by being applied on the basis of the initial payee of a traded instrument. However, it acknowledges that such a rule would be open to abuse and could not apply for a structured arrangement designed to engineer a hybrid mismatch (157). That rule does not seem practicable.

v. Conducting the tax audit. Taxing authorities would need to adopt new procedures to audit taxpayers' compliance with the anti-D/NI rules. In principle, to enforce rule 2, the auditor would need to review every instrument on which a payer claimed an interest deduction to determine whether a payee jurisdiction might not require the reporting of ordinary income in the same amount. Likewise, to enforce rule 3, the auditor would need to review every instrument on which the payee claimed tax-benefited income to determine whether the payer might have claimed a deduction for the same amount.

Discovery of questionable deductions under rule 2 and questionable tax-favored inclusions under rule 3 would obviously not be easy and would require massive training of auditors around the world. But suppose the auditor discovers a "suspicious" instrument. The requesting jurisdiction would need to provide the instrument to the counterparty jurisdiction through international exchange procedures. But the requesting jurisdiction would not merely be requesting documents or factual information from the counterparty jurisdiction as is typical under international information sharing. Rather, the question is a legal one — namely, the tax consequences of the particular instrument in the counterparty jurisdiction. This is like a request to the IRS for technical advice.

The tax authorities in the counterparty jurisdiction might not give priority to giving legal advice to jurisdictions around the world to help them audit their own taxpayers. The counterparty jurisdiction might not even have adopted the anti-D/NI rules, in which case it might have no interest in enforcing the anti-D/NI rules against counterparties of its own residents, and it might not expect to ever make a comparable request to other jurisdictions. As a result, the wait by a requesting jurisdiction for a response from the counterparty jurisdiction could be quite long. It is also possible that the counterparty jurisdiction would simply reply that the law in its jurisdiction is unclear.

The process might be simplified if, for purposes of applying rule 2 in the payer jurisdiction, the tax position taken by the payee on its own tax return is considered presumptively correct. Likewise, for purposes of applying rule 3 in the payee jurisdiction, the tax position taken by the payer on its own tax return could be considered presumptively correct. This would allow the requesting jurisdiction to request information from the counterparty jurisdiction limited to the tax position reported by the counterparty, as opposed to the correct legal position in the counterparty jurisdiction.

Of course, such a provision would raise serious privacy concerns in the counterparty jurisdiction. Also, even if that information was provided to the requesting jurisdiction, it would be no more than a presumption. The anti-D/NI rules are based on the actual law in the counterparty jurisdiction, not the tax position taken by the counterparty (92, 94). This rule makes sense, because difficult issues would arise if the substantive tax result to one party depended solely on the tax position taken by another party in another jurisdiction.

vi. Consequences of the tax audit. The interrelationship of payer and payee tax results under the anti-D/NI rules will cause considerable complexity for tax audits. Suppose the parties believe an instrument is a debt/equity hybrid, the payer jurisdiction has adopted rule 2, and rule 1 has not been adopted by the payee
jurisdiction or does not apply. Consistent with the intended characterization, the payer does not claim an interest deduction because of rule 2, and the payee reports dividend income taxed at a favorable rate. Then the payee jurisdiction claims the instrument is debt in that jurisdiction, the payee concedes the case or loses in court, and the payee pays tax on ordinary income for past periods.

The payer is now no longer subject to rule 2 for past periods and becomes retroactively entitled to interest deductions. However, the payer would not even know about the payee’s loss unless the payee notifies the payer voluntarily or in accordance with a contractual obligation. If the payer is notified, the payer must file amended tax returns for past periods to claim the deductions. If the payer is concerned that its statute of limitations might run before the payee’s situation is resolved, the payer will be required to file a protective refund claim in case the payee’s tax benefits are denied. This would be an entirely new category of protective refund claim, keeping the statute open because of the possibility of an inconsistent tax result to a different and possibly unrelated party in a different taxing jurisdiction based on the local tax law in that jurisdiction.

The same statute of limitations issue would arise for a payee reporting ordinary income under rule 1 or rule 3 on an instrument the parties believe is a debt/equity hybrid. If the payer jurisdiction successfully claims the instrument is equity and the payer is not entitled to its interest deductions, the payee is then not subject to rule 1 or rule 3 for past periods and would need to file refund claims.

The statute of limitations can also be a problem for a tax authority. Suppose the payer and payee both treat an instrument as debt, rule 1 does not apply to the payee, and the payee later files an amended return claiming the instrument is equity in the payee jurisdiction. If the payee is successful, the payer would retroactively be subject to rule 2, and the tax authority in the payer jurisdiction might need to file a protective claim against the payer in order to keep the statute open.

Finally, suppose the payer and payee take inconsistent positions from the start. Assume rule 1 does not apply, the payer jurisdiction has adopted rule 2, the payer claims interest deductions on the theory that the instrument is debt in the payee jurisdiction, and the payee claims a favorable tax rate for dividends on the theory that the instrument is equity in the payee jurisdiction. The result is D/NI. Note that rule 3 would not apply to the payee because the payer jurisdiction has adopted rule 2.

If the tax authorities discover these inconsistent positions, they would both need to act in order to protect their mutual interest and prevent whipsaw. The payer jurisdiction would claim that the interest deduction is disallowed under rule 2 (because the instrument is equity in the payee jurisdiction), and the payee jurisdiction would claim that the payee is not entitled to favorable tax treatment for dividends (because the instrument is debt in the payee jurisdiction).

Normally, when two U.S. taxpayers take inconsistent positions, the IRS tries to protect the fisc by having the taxpayers dispute the issue among themselves in a single judicial proceeding. Here, a single proceeding would be impossible because the two proceedings are in different jurisdictions. In theory, inconsistent outcomes in the two jurisdictions could result in D/NI or double taxation. However, because the legal result in the payer jurisdiction depends on the tax characterization of the instrument in the payee jurisdiction, presumably the court in the payer jurisdiction would defer to the court in the payee jurisdiction. However, if the tax authority in the payee jurisdiction concedes or settles the case without a judicial determination, a trial might be needed in the payer jurisdiction to determine the tax law in the payee jurisdiction. If the payer wins that case on the ground the instrument is debt in the payee jurisdiction, the result is D/NI.

vii. Double tax from inadvertent hybrids. A hybrid would not normally be structured to result in double tax. However, a double tax could result from an inadvertent hybrid. For example, suppose an instrument is intended to be debt in both the payer and payee jurisdictions but the payer jurisdiction determines the instrument is equity and disallows the payer interest deduction. If the payee jurisdiction continues to treat the instrument as debt, or otherwise continues to require income inclusion at ordinary rates, the result is “no deduction/inclusion” on a hybrid instrument.

f. Tax rates.

i. Multiple payee tax rates on ordinary income. Suppose the payee jurisdiction taxes different taxpayers at different rates on ordinary income. The requirement for avoiding rule 3 is that the item of income be taxed at “the taxpayer’s full marginal rate” without any tax relief applicable to particular categories of payment (94). As a result, D/NI does not arise if a payment is taxed at the payee’s ordinary income tax rate even though other kinds of taxpayers in the payee jurisdiction might be subject to a higher tax rate on ordinary income.

But suppose a single type of taxpayer is subject to different rates of tax on different kinds of operating income (for example, a higher rate on oil-related income). It is unclear whether this causes D/NI to arise if the payment on the hybrid is not taxable at the highest possible rate. Hopefully, the answer would be no as

41Cf. section 385(c) (the holder of an instrument is bound by the issuer’s initial classification of the instrument absent disclosure on the holder’s tax return).

42See Rev. Rul. 94-28, 1994-1 C.B. 86 (if debt is recharacterized as equity for tax purposes, stated interest is ineligible for the dividends received deduction because the holder has creditor remedies that protect it from risk of loss).
long as the income on the hybrid is taxable at the same rate as many kinds of operating income.

**ii. Reduced payee tax rate on dividends.** Rule 2 disallows the payer a deduction “to the extent” the payment is not included in the ordinary income of the payee (83(a)). Suppose the payee jurisdiction includes the entire payment in income but taxes that income at a rate that is less than the rate on ordinary income. For example, assume the ordinary income tax rate is 40 percent and the payment is treated as a dividend taxable at 20 percent. Literally, none of the payment is taxable as ordinary income, so the entire payer deduction would be disallowed by rule 2. However, rule 2 would logically disallow only 50 percent of the deduction. This would be the case if half of the payment was taxed as ordinary income and the other half was exempt from tax (108(a)). The actual tax liability to the payee is the same in both cases. The disallowance being limited to 50 percent is not clear from the discussion draft but appears to be the accepted view.\(^4\)

**iii. Reduced payee tax rate on all investment income.**

Suppose the payee is taxed on a payment at less than the ordinary rate in the payee jurisdiction, but the hybrid nature of the instrument does not cause a reduction in the payee’s tax liability. The discussion draft does not deal with this case, but the anti-D/NI rules should not apply.

For example, those rules should not apply to a debt/equity hybrid as long as dividend income is taxed in the payee jurisdiction at the same (or a higher) rate than the rate for interest income, even if the rate on both is lower than the rate on operating income. Similarly, the anti-D/NI rules should not apply to a straight debt instrument with no imputed interest even if the interest income is taxed at a favorable rate or is exempt from tax in the payee jurisdiction. Likewise, those rules should not apply if the payee jurisdiction has a consumption tax under which all investment income is included in income as ordinary income but an offsetting deduction is allowed for reinvestment. In these cases, there is no tax reduction in the payee jurisdiction as a result of the hybrid nature of an instrument, even though the income is taxed at less than ordinary rates.

However, even if a payee jurisdiction taxes all investment income at the same positive rate, the anti-D/NI rules can still apply if there is a different definition of income in the payer and payee jurisdictions. For example, rules 2 and 3 could still apply if the payer jurisdiction allows a deduction for imputed interest on a debt/debt hybrid that the payee jurisdiction does not recognize as income. To be sure, even in this case, rules 2 and 3 should not apply if the payee jurisdiction exempts all investment income or all interest income from tax, since there would again be no tax saving from the hybrid nature of the instrument.

**iv. Illusory payee tax rate.** Suppose the payee jurisdiction in form taxes the income on the hybrid instrument at high ordinary income rates, but the tax at the high rate is never paid in practice because of deductions allowed in the jurisdiction. If deductions of this type are generally allowed against all ordinary income in the jurisdiction, this is simply a reduction in the effective tax rate on all ordinary income in the payee jurisdiction, and the anti-D/NI rules should not apply. However, if the deductions are generally allowable only against specific types of income, including income from the hybrid, the anti-D/NI rules would apply (94).

**v. Low payer tax rate.** The anti-D/NI rules can lead to extreme penalties when the payer jurisdiction has a very low tax rate, the payee jurisdiction has a high tax rate, and the payment is subject to favorable rates in the payee jurisdiction. For example, suppose the payee jurisdiction taxes ordinary income at 30 percent and dividends at 10 percent. As usual, if the payer jurisdiction has no tax, the anti-D/NI rules do not apply and the dividend is taxed at 10 percent.

However, if the payer jurisdiction has, say, a 1 percent tax rate, either rule 1 or rule 3 would cause the payee jurisdiction to tax the hybrid payment at 30 percent rather than 10 percent, all on account of a 1 percent deduction in the payer jurisdiction. Rule 2, however, would only cause disallowance of the 1 percent deduction in the payer jurisdiction.

**vi. Disregard of withholding taxes.** The anti-D/NI rules do not take account of withholding taxes imposed on the payee by the payer jurisdiction. This result is criticized in many of the public comments.

The rationale for rule 2 is the tax savings to the payee from the hybrid nature of the instrument. If payments to the payee are subject to withholding tax, it would be logical to take that tax into account in determining whether the payee is paying less total tax because of the hybrid nature of the instrument. It should not matter whether the payee is paying income tax to the payee jurisdiction or withholding tax to the payer jurisdiction.

For example, consider a debt/equity hybrid in which the withholding tax rate on interest in the payer jurisdiction is 15 percent, the payee jurisdiction taxes dividend income at 5 percent, and the ordinary income tax rate in the payee jurisdiction is 15 percent. If the payee jurisdiction allows the 15 percent withholding tax credit to shelter the 5 percent tax on the dividend income but not the tax on other income, the payee has saved no tax as a result of the hybrid nature of the instrument (15 percent either way). As a result, it would be logical not to apply rule 2 to the payer. Note that rule 3 would have no effect on the payee under these facts, because it would impose a 15 percent tax rate on the dividend income that would still be offset by the FTC.

However, the case for applying rule 2 in the above example is stronger if the payee jurisdiction allows the

\(^{43}\) Sheppard, supra note 36, at 1090.
payee to use the remaining 10 percent tax credit to shelter other income. The hybrid nature of the instrument has then produced a tax credit to the payee that would be unavailable from a non-hybrid debt instrument, when the full credit would be absorbed against the 15 percent tax rate on ordinary income.

Now suppose that rule 2 applies under these principles because, even after taking into account withholding taxes, the payee is taxed at a lower rate than ordinary income in its jurisdiction. In applying rule 2, the withholding tax should still be considered in determining the effective tax rate payable by the payee on the dividend. This will reduce the portion of the payer’s deduction that is disallowed.

\( g. \) **Timing differences.** As noted above, timing differences between payer deductions and payee inclusions are disregarded in determining whether D/NI exists. This makes it possible to ignore differences between accrual basis payers and cash basis payees. However, this rule raises several questions.

i. **What is a timing difference?** Suppose that the payer accrues current deductions on an instrument, and the payee jurisdiction allows the payee to defer the inclusion of the corresponding amounts in income until the amounts are paid at maturity of the instrument. If those amounts will inevitably be taxed at ordinary income rates by the maturity of the instrument, there is a timing difference and no D/NI (88).

However, consider the case discussed in Part III.B.5.a of a debt/equity hybrid when the issuing corporation has no E&P and the payee corporation taxes dividends and capital gains at ordinary income rates. The payee is not taxed currently on a distribution because of the lack of E&P but will be taxed eventually at ordinary income rates when the stock is sold. It is unclear whether this is a timing difference that avoids the anti-D/NI rules, since the payee can wait as long as it wants before selling the stock (and the value of the stock can decline before it is sold).

Next, suppose that the payee in either of the two preceding paragraphs is an individual who will be taxed at ordinary income tax rates at the maturity of the debt or sale of the stock, respectively. However, suppose the payee jurisdiction allows a stepped-up tax basis at death, in which case no tax will be payable on the amount deducted by the payer. If rule 2 would not otherwise apply to the payer because the only difference is a timing difference, it is unclear whether the possibility of a step-up would cause rule 2 to apply initially. If rule 2 does not initially apply, it is not clear if the payer must recapture its deduction on the death of the payee.

Alternatively, if rule 3 applies, the payer will have claimed a deduction. It is unclear whether rule 3 would then disallow the step-up in basis on death or treat the ordinary income as income in respect of a decedent. That would be a quite unexpected application of rule 3.

Next, suppose that the payee would be taxed at ordinary income rates at the maturity of the instrument, resulting in nonapplication of rule 2, but the payee can sell the instrument before maturity at a favorable tax rate. (This is the U.S. rule for notional principal contracts.) Presumably, this ability to sell means that there is more than a timing difference, so rules 2 and 3 apply. Rules 2 and 3 would be considerably weakened if they do not apply in this case. However, if rule 2 applies, it must look not only at the formal characteristics of the tax laws of the payee jurisdiction but also at the tax planning opportunities available in that jurisdiction to avoid ordinary income tax. Rule 2 would be difficult to administer in that situation.

Next, assume the payee jurisdiction taxes OID as ordinary income at maturity but that before maturity, the payee jurisdiction changes its law to allow the OID to be taxed as capital gain at maturity. It is unclear whether rule 2 would require the payer to recapture its ordinary deductions taken over the life of the debt.

Finally, suppose the payer issues a zero interest purchase money note to the payee to purchase an asset, the payer jurisdiction imputes an interest deduction on the note, and the payee jurisdiction does not impute interest income. This is a debt/debt hybrid subject to the anti-D/NI rules (64(a)). Yet the deduction to the payer reduces the payer’s tax basis in the purchased asset. If the payer will pay tax at ordinary income rates on disposition of the purchased asset (or have less depreciation deductions while holding the asset), the payer’s initial deduction is only a timing difference.

There is no exception to the application of rule 2 in this situation. The exception for timing differences applies only to timing differences between the payer’s deduction and the payee’s income, not between the payer’s deduction and the payer’s income. As a result, rule 2 disallows the payer’s imputed interest deduction.\(^{44}\) Similarly, if the payer jurisdiction has not adopted rule 2 and the payee jurisdiction has adopted rule 3, the payee would be required to include the imputed interest in income even though the payer receives only a timing benefit from the deduction.

ii. **Long-term deferrals.** Action 2 includes long-term deferrals as a target. Nevertheless, the discussion draft states that timing differences are disregarded, without any reference to the deferral period. Suppose a payee jurisdiction replaces its existing dividend exemption with a rule that dividend income is taxable as ordinary income, but the tax is deferred and payable ratably over 50 years without interest, or taxable in a lump sum in 50 years without interest. Is this a timing difference that avoids the application of rule 2 in the payer jurisdiction?

\(^{44}\)The payer could be partially made whole if it was allowed to capitalize the disallowed interest deduction. However, rule 2 does not allow the capitalization of a deduction that it disallows.
iii. Timing for rule 3 income inclusion. Under rule 3, the payment must be included as ordinary income of the payee if it is deductible by the payer. Payment is defined elsewhere to include distributions or the accrual of money (21). Literally, this would require the payee to include amounts in income as the amounts were accrued as deductions by the payer. Such a rule would make little difference for a current payment of interest, when the income inclusion to the payee (even if the payment is treated as a dividend) would normally occur at around the time of the deduction to the payer.

However, the timing of income inclusion to the payee could be a significant issue if the payer jurisdiction allows an interest deduction before the payee jurisdiction would require an income inclusion. For example, in a debt/equity hybrid, the deduction for OID or accrued and unpaid interest could be long before the dividend inclusion. Rule 3 literally requires the inclusion of income to match the payer’s deduction, meaning an acceleration of income and not only an increased tax rate to the payee.

Logically, however, an inclusion of ordinary income at the time of payment to the payee should be sufficient. That accrual into income would be enough to prevent the application of rule 2 in the payer jurisdiction. Since rule 2 does not apply merely because of payer deductions before payee inclusions into income, rule 3 should not apply in the same situation.