

Cross-Border Hybrid Financing Arrangements

Cross-border hybrid financing arrangements have been a standard feature of global structures of multinationals for many years. Hybrid arrangements provide the benefit of different tax treatment of the same financing transaction in two countries. Recently, hybrid financing instruments and entities have come under intense scrutiny, requiring consideration of the impact of possible future changes to the tax laws.

Hybrid instruments are commonly used to fund members of a multinational group. The instrument generally is classified as equity by the investor's country and as debt by the borrower's country. This treatment provides an interest deduction to the borrower, but the investor is not subject to taxation on the yield.

To illustrate, a U.S. company may provide funding to a French subsidiary for business expansion. If the U.S. company loans the funds to the French subsidiary, interest on the loan generally is deductible in France but is also subject to U.S. taxation. Alternatively, if the U.S. company funds the French subsidiary with equity, the yield on the stock is not subject to U.S. taxation until distributed as a dividend, but there is generally no deduction in the foreign country. If instead a properly structured hybrid instrument is used, the parties can obtain an interest deduction in France and no current income inclusion in the United States.

Features of a hybrid instrument that support U.S. equity treatment include: not being labeled as a loan, a distant maturity date, interest or principal that is contingent on profits, interest that is payable in stock, an option for the issuer to convert the instrument into stock and a lack of full creditor rights for the holder.¹ From a U.S. tax perspective, the accrued yield on a hybrid instrument treated as equity is not included currently in income. Moreover, if arrangements are made to recontribute any actual payments of yield immediately back to the foreign subsidiary, or the interest is paid in additional shares of stock, the payments also will not be included in income.²

The same benefit can be achieved using a hybrid entity. To illustrate, a U.S. parent forms a U.K. corporation and transfers a U.K. operating company to the new U.K. subsidiary. An election is made to disregard the intermediate U.K. subsidiary for U.S. tax purposes. The U.S. parent makes a loan to the disregarded U.K. subsidiary, which then contributes the funds to the U.K. operating company for use in its business. Under group relief rules, the interest expense of the U.K. subsidiary generally can be deducted against the profits of the U.K. operating company. Because the U.S. parent loan is made to a disregarded entity, the loan is ignored for U.S. purposes, and thus does not give rise to any interest income.³

A reverse hybrid structure can provide a similar tax benefit. For example, a U.S. parent may form a Dutch CV treated as a partnership for Dutch purposes and as a corporation for U.S. tax purposes (by election). The U.S. parent capitalizes the Dutch CV with equity, and the Dutch CV loans the funds to its wholly owned operating subsidiary, a Dutch BV. Interest on the loan is deductible by the Dutch BV, but the Dutch CV is not subject to tax in the Netherlands because it is a transparent entity. The United States does not directly tax the income of the Dutch CV because it is classified as a corporation. Also, Subpart F should not apply because the interest is either ignored if the Dutch BV is a disregarded



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entity or qualifies for the same country or look-through exception if the Dutch BV is a corporation.⁴

A foreign parent can fund a U.S. group with a hybrid instrument that is treated as debt for U.S. purposes and as equity for foreign purposes.⁵ Interest will be deductible in the United States when paid, and often the yield (treated as a dividend) will be excluded from the income of the foreign funding corporation under a participation exemption. The same hybrid result can be achieved with a repurchase agreement, where a U.S. company sells stock in a U.S. subsidiary to a foreign affiliate subject to an agreement by the U.S. company to repurchase the stock for a fixed amount and a return based on an interest factor. The U.S. company is treated as borrowing the funds from the foreign affiliate for U.S. tax purposes, and the foreign affiliate is treated as owning stock in the U.S. subsidiary for foreign tax purposes.⁶

A similar result is achieved with a reverse hybrid structure. A foreign parent can organize a U.S. partnership to own the U.S. group, and the partnership can elect to be classified as a corporation for U.S. tax purposes. The partnership borrows from a third party. The interest is deductible for U.S. tax purposes against the income of the U.S. operating subsidiaries under the consolidated return regulations and also deductible by the foreign parent because the borrower is a transparent entity.⁷

Although the United States has adopted narrow, targeted rules to address particular aspects of certain cross-border financing arrangements, it has not enacted any general rules that would prevent the benefits described above. As mentioned, the Obama Administration in its 2015 Budget has proposed rules to deny tax benefits for certain hybrid arrangements, but Congressional action on those proposals is not imminent. Moreover, the courts have recently held that use of cross-border hybrid financing arrangements is “legitimate tax planning.”⁸

The OECD has issued a report aimed at “neutralizing” the effect of “hybrid mismatch arrangements.” The report targets many of the commonly used cross-border hybrid financing arrangements. It generally recommends that either an interest expense not be allowed where the investor does not recognize income or that the income be taxable in the country of the investor.⁹ Some countries have already adopted or are considering enacting rules like those discussed in the OECD report, but other countries have raised concerns and it is not certain that the proposals will be adopted on a global basis (or at least not for a number of years).

Despite the recent attention, multinationals should not abandon the use of cross-border hybrid financing arrangements, but they should be prepared to modify them as countries change their laws.

ENDNOTES

¹ See *Pepsico Puerto Rico Inc.*, 104 TCM 322, Dec. 59,199(M), TC Memo 2012-269 (“loan notes” were equity for U.S. purposes, but debt for Dutch purposes).

² It is usually preferable to structure the instrument so that it qualifies as common stock rather than preferred stock for U.S. tax purposes to avoid collateral issues that may arise under Code Sec. 305. We also note that when the yield is subject to U.S. taxation, it will be treated as a dividend and pull up deemed paid foreign taxes, which can be used as a credit to offset U.S. tax on the dividend. Code Secs. 901 and 902. *But see* Reg. §1.909-2T(b)(3) (withholding tax on amounts not included in income are not currently creditable). See Lowell D. Yoder, *Use of Cross-Border Hybrid Instruments in*

Light of Recent Developments, INT’L TAX J., March–April 2013, at 3.

³ The dual consolidated loss (“DCL”) rules should not apply to limit any interest deduction on obligations of the U.S. parent. Reg. §1.1503(d)-7(c), *Ex. 23. Cf., Id., Ex. 7* (DCL rules would apply if the disregarded U.K. subsidiary borrowed from a third party).

⁴ Code Sec. 954(c)(3), (c)(6). The Obama Administration has proposed to prevent the Subpart F exceptions from applying to interest payments made to a reverse hybrid (but the proposal would not apply if the interest is ignored for U.S. tax purposes). See Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2015 Revenue Proposals* (March 2014), p. 62 (“2015 Green Book”).

⁵ See *NA General Partnership & Subsidiaries*, 103 TCM 1916, Dec. 59,094(M), TC Memo 2012-172 (“loan notes” from U.K. parent to U.S. subsidiary treated as debt for U.S. purposes and as equity for U.K. purposes).

⁶ See Rev. Rul. 74-27, 1974-1 CB 24; Rev. Rul. 77-59, 1977-1 CB 196; Rev. Rul. 79-108, 1979-1 CB 75.

⁷ See Reg. §1.894-1(d)(2)(iii), *Ex. 3*; T.D. 9315, 72 F.R. 12902 (March 19, 2007) (DCL rules should not apply). A proposal in Obama’s 2015 Budget would deny a deduction for the interest expense because it is also deductible in a foreign country. 2015 Green Book, at 61.

⁸ See cases cited at endnotes 1 and 5.

⁹ OECD, “Release of Discussion Drafts on Action 2 (Neutralise the Effects of Hybrid Mismatch Arrangements) of the BEPS Action Plan” (March 19, 2014).

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