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Neutralizing Effects of Hybrid Mismatch Arrangements

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Neutralizing effects of hybrid mismatch arrangements

Peter Harris

The use of hybrid mismatch arrangements is one of the ways in which large multinationals can end up paying effectively lower tax rates than the small domestically bound enterprises that multinational often compete with. This is a major concern for most countries, including developing countries. Hybrid mismatch arrangements are not new in international tax.[1] Conceptually, it has always been possible to engage in such arrangements for the purpose of minimising tax. What has changed is the proliferation of hybrid mismatch arrangements, the ease with which they can be achieved and their comparative importance. This change is largely a function of the increase in electronic commerce and globalisation. Such arrangements are not 'wrong' per se – they are simply a function of two countries having, typically unilaterally, decided not to tax a particular cross-border dealing or give some other favourable tax effect (such as a deduction). What might be considered 'wrong' is the manner in which tax advisers and multinationals have in recent years aggressively sought out and exploited such arrangements.

Before discussing manners in which 'hybrid mismatch arrangements' can be 'neutralised', it is necessary to identify exactly what such arrangements are. This is not an easy task because the phrase 'hybrid mismatch arrangement' is not logically bound from a tax perspective and so it is only possible to discuss a generally understood meaning.[2] It is part of the purpose of this paper to identify that meaning and relate it to the fundamentals of income taxation.

The 'hybrid' part of the phrase means that, in a particular case (taken to be an 'arrangement'), two countries do not agree on the classification or characterisation of some feature of the arrangement that is fundamental for income tax purposes. From this perspective, all of the fundamentals of income taxation can give rise to 'hybrid arrangements'. So in order to understand the scope for hybrid arrangements it is necessary to investigate the fundamentals of income taxation.

The 'mismatch' feature is different and suggests that the different ways in which two countries view the particular arrangement produce some sort of inconsistent outcome when looked at in the whole. From this perspective, not all 'hybrid arrangements' give rise to 'mismatches' because in some cases the differing views of the two countries do not produce an inconsistent outcome. One of the complexities in seeking to establish rules to 'neutralise' hybrid mismatch arrangements is identifying which arrangements give rise to inconsistent outcomes. By the very nature of a hybrid mismatch arrangement, this means that the countries in question need to look closely at how the tax law in the other country applies to the arrangement. Historically, countries (especially source countries) have not looked closely or sought to understand or apply the tax law in another country interested in a cross-border arrangement (see below at 6.4). One core issue is whether it is realistic, even presuming high levels of cross-border cooperation between tax administrations, to believe that tax

person might be viewed as two persons for income tax purposes (such as the distinction between the personal capacity of a person and their capacity as a trustee of a trust). It is also possible for two or more persons to be given a single capacity for tax purposes, such as in the case of some tax consolidation regimes for group companies.

The rules that a country's income tax law adopts for identifying what constitutes a 'person' must, in principle, be capable of characterising every entity that is formed anywhere in the world. This is a function of globalisation and the breaking down of trade barriers. It is possible for an entity formed anywhere in the world to do business in a particular country. So, as a source state, a country must be able to say whether the foreign entity is a tax person or whether the persons underlying the foreign entity are the tax persons. Similarly, globalisation means that every resident of a country may invest in a foreign entity. Presuming the country taxes foreign source income of its residents, the country must be able to classify the type of foreign income derived from the foreign entity and that will require a classification of whether the foreign entity is a person or not for tax purposes.

The various ways in which an income tax law may classify 'persons' is fundamental to understanding the manner in which some hybrid mismatch arrangements operate, but there are other features of a person that can give rise to hybrid effects. In particular, an income tax law will characterise persons according to various types, e.g. individual, partnership, trust or company. An income tax law will incorporate a situs test for persons, usually based on the concept of residence. An income tax law must also deal with the eventuality of a person beginning to exist and a person ceasing to exist. An income tax law might also identify the relationship of a particular person with another person or persons, such as in the case of related individuals, group companies or other closely-held companies.

As for the activities through which income is earned, these are generally of three types – employment, investment and business, reflecting resources available for earning income. Income may be earned through the exclusive provision of labour – most employment falls into this category. Income may be earned through the exclusive provision or use of assets – often called 'investment'. Income may also be earned, in a myriad of combinations, through the use of labour and assets – most commonly referred to as 'business'. Just as it is possible that different countries classify 'persons' differently, it is common for countries to classify earning activities differently. Further, earning activities also demonstrate some fundamental features. Earning activities must be allocated as being conducted by particular persons. These activities may be allocated a particular situs (often related to the location of the individual activities making up the earning activity). It may also be necessary to deteaceteaceteaceteacetead [(l43 d9 l)-6(l)-6((y)16(a1)-1(c)4 Td [(, y)16(1t)-6(eagJ -0.0ovi)-(m)-6(a)-10

services are rendered (usually where the individual is who is physically performing the labour or where the services are used or consumed)

The use of assets is more complex (than the rendering of services) and an income tax law is likely to have more detailed rules associated with assets. There is the need to identify what constitutes an asset (or two or more assets) for income tax purposes, including a negative asset in the form of a liability. There is also a need to classify different types of assets and liabilities, which can be important because different tax consequences may attach to the holding and sale of different types of assets and income derived from them. Third, assets must be allocated to particular persons (e.g. ownership) and the person's earning activities. Fourth, an income tax law is concerned with movements in the value of assets, whether while held (for depreciation purposes) or at least when they are disposed of (for purposes of calculating gains).

'Income' is the return derived from the provision of resources in the context of an earning activity calculated for a particular period, usually the tax year, less any assets used in the provision. In the context of a realisations based income tax (in practice the residual basis of all income taxes) this means netting of amounts paid against amounts received in the context of an earning activity.

Payments are the building blocks of the calculation of income and, as with other income tax essentials, payments must be identified and have certain fundamental features. A 'payment' is broadly the bestowal of value by one person on another person.[8] The ways in which a person may make a payment reflect the resources available to that person, i.e. the provision of labour, the use of assets, the ownership of assets or a combination of these. A payment may be made by one person transferring an asset, including cash, to another person. There is also a bestowal of value when one person gives up rights (an asset) that they have against another person (a liability). So the reduction of a liability is also a payment. This type of payment involves the destruction of an asset by one person without the acquisition of an asset by another person. The third type of payment involves the opposite, where one person uses their resources to create an asset that becomes owned by another person, even though the first person never owned the asset created. The fourth type of payment involves the payer permitting another person to use an asset that the payer owns. The fifth type of payment is similar and involves one person providing services (labour) for the benefit of another person.

Often countries don't agree on the fundamental features of a 'payment' and this disagreement gives rise to some common forms of hybrid mismatch arrangements. In particular, an income tax law must allocate payments to persons, earning activities, a location and perhaps to assets or liabilities. An income tax law must determine the quantum of the payment, especially when the payment does not involve a transfer of cash in the currency in which the tax base must be reported. An income tax law must determine the timing of the payment and, in particular, the tax period or periods in which the payment is to be recognised as having a tax effect. Finally, an income tax law often places critical importance on the character of a payment (not to be confused with its form), i.e. a label assigned to it which is usually

1.1.2 Mismatches as to payments and the fundamental features of payments

Disagreement between two countries as to any of the fundamentals of income taxation discussed under the last subheading may be exploited by taxpayers through the use of hybrid mismatch arrangements. However, as these fundamentals are cumulative in producing a tax liability, it is common that a mismatch with respect to one of the essentials may give rise to a mismatch with respect to another essential. For example, disagreement as to whom or what constitutes a person, may give rise to disagreement as to who owns an asset or who receives a payment with respect to use of the asset. Disagreement as to whether two persons are related may give rise to a disagreement as to the value at which a transaction

Example 1

Mismatch in Identifying Payment - Deduction but No Income

Z, a resident of Country A, owes money to Y, a resident of Country B. Z enters into an arrangement with its creditors whereby part of the debt owed to Y is written off. Under the Country B tax law Y can deduct the amount of the debt that it writes off. Under the Country A tax law Z is not required to report any in

not agree on who makes the payment. The income tax fundamental in issue (allocation of payment) is the same as in Example 2, but this is a different variation involving 'double dip' deductions. So Country B includes the payment in calculating Y's income, but both Country A and Country B grant a deduction for the payment to different entities, i.e. two deductions, one income. Again, this type of mismatch is often triggered in the context of payments made by hybrid entities.

Example 3
Mismatch in Maker of Payment - Double Dip Deduction

Y, a resident of Country B, receives a payment that is included in income. Country A considers that the payment is made by Z, a resident of Country A, and that the payment is deductible for Country A purposes. Country B

and Y are related and both Country A and Country B agree the market value of the asset is 150. Country A accepts the transaction at the price of 100 for tax purposes and considers that Z has no gain or loss. Because Z and Y are related, Country B applies a market value rule to the transaction and so considers the asset to have been purchased for 150. Country B proceeds to grant a deduction for that 150 (either through depreciation or on sale of the asset by Y).

There is a mismatch between Country A and Country B as to the price considered paid for the asset for tax purposes. The discrepancy of 50 (difference between 100 and 150) results in a tax benefit (deduction in Country B) with no pick up in Country A (no income or gain). In a reverse scenario (price considered received is higher than price considered paid), there is scope for application of corresponding adjustment rules in the transfer pricing provisions of tax treaties. While these rules protect taxpayers from many types of double taxation, in most countries they have no application in this scenario where the application of domestic rules results in under taxation.

Example 5 is a simple illustration of a mismatch between two countries that recognise a payment, but disagree as to the time at which the payment should be recognised for tax purposes. In this example, Country A grants Z a deduction for interest payments as they accrue over the three year term of the loan, e.g. because Country A tax law follows financial reporting in this regard. By contrast, Country B requires Y to include the interest in calculating income when it is received (cash basis). The example notes that source state taxation of the interest often does not resolve the timing mismatch because that taxation (like taxation in the residence state in this example) is most often imposed on a cash basis. This case should not be confused with similar examples that focus on other income tax fundamentals but also result in timing benefits across borders, e.g. where two countries don't agree as to who is the owner of an asset and so simultaneously both grant depreciation deductions for the asset (see Example 9).

Example 5
Mismatch in Timing Payment - Early Deduction but Late Income

Z, a resident of Country A, borrows money from Y, a resident of Country B. The loan is for a term of three years and the agreement requires Z to pay interest in one lump sum at the end of the three year period. Country A permits Z to deduct the interest for tax purposes as it accrues, e.g. one third of the interest in each of the three years. Country B does not tax the interest as income to Y until it is received in year three.

There is a mismatch between Country A and Country B as to the time at which the interest should be recognised for tax purposes. This gives rise to a cross border tax benefit because most of the interest is deductible in Country A in tax years before it is included in income in Country B. Commonly, this timing benefit is not resolved if Country A taxes the interest at source (e.g. by withholding) because withholding is typically only at the point the interest is paid, i.e. when, on these facts, Country B also taxes.

Example 6 is a simple illustration of a mismatch between two countries that recognise a payment, but disagree as to the character of the payment for tax purposes. In this example, Country A characterises the payment as interest for tax purposes and so grants Z a

deduction for it. By contrast, Country B characterises the payment as a dividend, grants indirect foreign tax relief (cross-border dividend relief) and so does not tax Y with respect to the receipt. The result is a deduction in one country with no inclusion in income in the other country. This case should not be confused with similar examples that focus on other income tax fundamentals but also result in a deduction with no inclusion in income, e.g. as in Examples 1 and 2.

Example 6
Mismatch in Characterising Payment - Deduction but Specific Tax Relief

Z Co, a company resident in Country A, issues perpetual, subordinated, profit sharing debentures to Y Co, a company resident in Country B. Country A characterises the return payable on the debentures as deductible interest. Country B characterises the return as dividends and grants a participation exemption (exemption for dividends paid between two companies) to Y Co with respect to receipt of the dividends.

There is a mismatch between Country A and Country B as to the character of the return payable on the debentures (interest or dividends). This gives rise to a cross-border tax benefit (deduction in Country A) with no pick up in Country B (exemption granted). There are many variations on this style of mismatch. Some occur, as here, even though the two countries classify the investment in the same manner. Others occur because the two countries characterise the investment differently, e.g. debt or equity.

1.1.3 Mismatches as to earning activities and the provision of resources

Disagreement between countries in identifying earning activities can also give rise to

variations of this style of mismatch. Some occur even though the two countries classify activity in the same manner, as in Example 8 below.

Disagreement as to whether a source state tax threshold such as permanent establishment ('PE') is met can also give rise to a mismatch, as illustrated in Example 8. Here the two countries agree as to the nature of the earning activity being conducted (business) and who is conducting it. However, the two countries do not agree as to whether there is sufficient activity to constitute a PE. This might happen due to disagreement as to which transactions are considered conducted or assets owned by the person, and so is related to Example 9. In Example 8, Country A and Country B do not agree as to who contracted with the customers of Y's goods. As a result, Country A thinks the activity of Y is insufficient so as to constitute a PE, while Country B thinks it is sufficient and so grants foreign tax relief.

Example 8
Mismatch of Who Contracts - No Income but Foreign Tax Relief

Y, a resident of Country B, sells stock in Country A through a commissionaire arrangement. Under this arrangement, the commissionaire, Z who is resident in Country A, sells Y's products to third parties in Z's name but on account of Y. Country A considers that Y is not bound by the contracts with third parties and so is not conducting the activity associated with these contracts. As a result, Country A does not consider Y to have a PE there and does not tax Y (but does tax Z on commission received from the sales). By contrast, Country B considers Y to be conducting business in Country A through an agent (Z) and so considers that Y does have a PE in Country A. As a result, Country B grants Y foreign tax relief in the form of an exemption for profits from the sales.

The mismatch in this example produces results similar to those in Example 7.

Example 9 demonstrates a simple mismatch as to who is the owner of an asset, which gives rise to double dip depreciation. Like in Example 8, Example 9 involves a mismatch in the fundamentals of a provision of resources, in this case whether the provision of an asset is by way of transfer or lease. In this example, Country A characterises a finance lease as a transfer of an asset with debt financing. By contrast, Country B characterises the finance lease as a lease. The result is that Country A considers Z the owner of the asset and Country B considers Y the owner of the asset and so both countries simultaneously grant tax depreciation to two different persons. Depending on the facts, it is possible for the reverse scenario to also give rise to tax benefits, i.e. where Country A considers Y to be the owner of the asset and Country B considers Z to be the owner of the asset. If the asset is an appreciating asset, neither country may tax a gain arising on the disposal of the asset.

1.2 What is covered by OECD Action 2

Categorisation of hybrid mismatch arrangements in the OECD's Action 2 Discussion Draft ('OECD Draft') is very different from the above categorisation. This is because Action Plan 2 is targeted at only some types of cross-border mismatch arrangements that may give rise to cross-border tax benefits. In particular, Action 2 only targets hybrid instruments and entities.[13] So it is limited in scope to 'hybrid financial instruments and transfers', 'hybrid entity payments' and 'imported mismatches and reverse hybrids'.[14] It seems an overstatement for the OECD to suggest that '[t]hese categories describe, in general terms, the various ways in which a hybrid technique can be used to engineer a mismatch in tax outcomes'.[15] A

there is little detail on apportionment and inevitably apportionment is more difficult to administer (and see below regarding bifurcation in the context of quantification of amounts)

Second, it is not clear how deduction and inclusion interface with the 'transactional' part of an income tax. The OECD Draft suggests that 'deduction' is

> intended to refer to an item of expenditure that is taken into account... in calculating the taxpayer's net income. The definition includes "equivalent tax relief" in order to cover relief

quantity and character of payments ultimately passing from the jurisdiction of the investment to the jurisdiction of the investor. The novelty of hybrid mismatch arrangements is that they-2(d m)-

conceptual framework outlined under heading 6.1 and by comparison with the 13 examples discussed there. The 13 examples (highlighted in green) are intentionally spread across the potential types of mismatch. By comparison, the OECD examples are highlighted in yellow.

Box 1
Categorising Hybrid Mismatch Examples

- Payments
  - Identification
    - Example 1
  - Allocation of Recipient
    - Example 2
  - Allocation of Payer
    - Example 3
  - Quantification
    - Example 4
  - Timing
    - Example 5
  - Character
    - Example 6
- arning Activities and Provision of Resources
  - Identification of Earning Activity
    - Example 7
  - Threshold of Earning Activity
    - Example 8
  - Ownership of Asset
    - Example 9
    - OECD Figure 2, Collateralised Loan Repo
    - OECD Figure 3, Bond Lending Repo
    - OECD Figure 19, Collateralised Loan Repo
    - OECD Figure 20, Share Lending Repo
  - Character of Asset
    - Example 10
    - OECD Figure 1, Hybrid Financial Instrument
    - OECD Figure 4, Hybrid Financial Instrument with Tax Exempt Holder
    - OECD Figure 5, Right to Deferred Purchase Price
    - OECD Figure 12, Importing Mismatch from Hybrid Financial Instrument
    - OECD Figure 16, Foreign Tax Credit Generator Transaction involving use of Hybrid financial instrument
- Persons and Personal Characteristics
  - Identification
    - Example 11
    - OECD Figure 6, Double Deduction Structure Using Hybrid Entity
    - OECD Figure 7, Double Deduction Structure Using a PE
    - OECD Figure 9, Disregarded Payments Made by a Hybrid Entity to a Related Party
    - OECD Figure 10, Disregarded Payments Made by a Permanent Establishment
    - OECD Figure 11, Payment to a Foreign Reverse Hybrid

The OECD Draft contains no pure examples of mismatches with respect to payments, only such mismatches triggered by mismatches as to allocation and character of assets and identification of persons. The OECD examples focus on mismatches as to ownership of assets, character of assets, identification of persons and dual residence. This raises fundamental questions as to whether any other types of mismatches are intended to be covered (it seems that at least some are). Further, this is not to suggest that the OECD Draft intends to cover all mismatches that fall within these categories, and, in particular, the OECD examples are essentially

instrument).[37] Notably, the OECD Draft contains no example relating to a finance lease of a tangible asset (contrast Example 9 above).

It is not clear whether under the OECD Draft 'hybrid transfers' are also limited to 'financial instruments', but that seems the intention. The core feature of such transfers seems to be that they result in a mismatch as to who is the owner of an asset (although, as noted below at 6.4.5, Figure 19 seems to lack some detail). As the OECD Draft examples note, such mismatches often result from different characterisations of repurchase agreements.[38] As Example 9 above notes, such a mismatch can also arise as a result of different characterisation of a lease (finance versus operating).

1.2.3 Hybrid entity payments

The hybrid entity payments part of the OECD Draft only covers payments made by hybrid entities. These are of two basic types. The first involves two countries recognising that a payment is made by different entities, with each granting a deduction. This was discussed above at 6.1.4 and is illustrated by OECD Figure 6.[39] The second involves one country recognising a payment made by an entity while another does not recognise a payment at all. This was illustrated in Example 11, discussed above at 6.1.4, and see OECD Figure 9.[40]

Conceptually, the second type of mismatch covered under this heading is confusing. It is true that it involves a payment made by a hybrid entity, but equally it involves a payment received by a hybrid entity.[41] So inherently this second type is related to what the OECD Draft refers to as a 'reverse hybrid mismatch'.[42] Indeed, many of the OECD examples overlap in unexplained manners. The overlaps seem to result from trying to relate the examples to ill-defined observations rather than relating them to income tax fundamentals.

Two of the examples given by the OECD reveal the potential depth of the entity mismatch problem. The problem is not just with the identity of an entity in the traditional sense, e.g. identifying what is a 'corporation' for tax purposes. The problem is with identifying the levels at which income is calculated and has a tax effect.

The first OECD example (Figure 7) demonstrates that PEs are hybrid entities and can create mismatches as to payments.[43] Article 7(2) of the OECD Model tax treaty requires a PE to calculate its income in the host state as if it were separate and independent of the rest of

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[37] International Accounting Standard 32 para. AG9 confirms that a finance lease is a financial instrument but an operating lease is not.

[38] Figures 2, 3, 5 & 20; OECD (2014) pp. 21, 23, 36 & 74, respectivel-6(f)aldnd (2

the enterprise of which it is a part.[44] The same prescription is not required where a residence state calculates an enterprise's income (although it is required for purposes of calculating foreign tax relief under Article 23). Hence, tax treaties treat PEs as separate persons for income tax calculation purposes in the host state, but often that is not the case in the residence state. Hence, a PE is often a hybrid that can give rise to mismatches of the type identified in Example 3 above (OECD Figure 6).

The second OECD example (Figure 10) demonstrates that the erosion of the separate identity of corporate group members resulting from group regimes can give rise to the same style of mismatch.[45] This is most obvious where a country adopts a consolidation regime that removes the separate identity of a group member. However, other forms of group relief can produce similar results, the critical feature being the ability to have a transaction between two group companies ignored or its tax consequences deferred.

A third OECD example (Figure 8) demonstrates a different point.[46] This example is similar to Example 13 above and involves a dual resident company and the dual use of deductions/losses. A similar result can be achieved with a PE, as in Figure 7. These examples involve no disagreement between the countries as to the fundamental features of a payment. Both countries agree as to who made the payment and even that the payment made is attributable to activities in Country B. The fundamental problem in these cases is with what tax treaties and foreign tax relief don't deal with.

Tax treaties and foreign tax relief only deal with positive tax results and seek to ensure that the same amount of income is not subjected to tax twice. This is most clear in the obligation of the residence state to provide foreign tax relief.[47] However, tax treaties and foreign tax relief are not symmetrical. In the context of negative results (deductions, losses, payment of foreign tax), there is no attempt to ensure that the benefit of the negative result is not duplicated in the source (host) and residence (investor) states, although domestic law can prevent this. This duplication is precisely what is happening in OECD Figure 7.

A symmetrical approach would be that if the residence country defers to the tax consequences in the source state where income is taxable in that state, it should also defer recognition of a negative result where the negative result is granted relief in the source state.[48] There is a similar problem in the dual residence scenario (Example 13 above, OECD Figure 8). A tax treaty residence tiebreaker is only effective for purposes of relieving double taxation and not for purposes of ensuring that the same relief is not claimed twice. Again, the OECD Draft does little in terms of explaining this fundamental limitation of tax treaties,[49] but rather mixes conceptually dissimilar examples.

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[44] That is, the Authorised OECD Approach; see OECD (2010), e.g. at para. 3.

[45] OECD (2014) p. 49.

[46] OECD (2014) p. 47.

[47] Of course, the removal of double taxation is far from perfect. Generally, see Harris (2013b).

[48] Conceptually, the potential for dual benefits is not limited to deductions and losses. For example, a PE may have foreign income and pay third country tax. It is possible for that third country tax to be granted a foreign tax credit in both the PE state and the head office state, including by way of transfer to other group members (e.g. through a consolidation regime).

[49] Rather, it glosses over the issue with technical terms including 'duplicate deduction' and 'dual inclusion income', which, while accurate, are unnecessarily confusing.

1.2.4 Reverse hybrid and imported mismatches

The OECD Draft categorises the receipt of payments by a hybrid entity separately from other hybrid payments and refers to them as 'reverse hybrid structures'. While this may (or may not) be a phrase used in practice, it is anti-intuitive and does not explain what is going on, especially by comparison to payments made by hybrid entities. The potential for income to disappear in the context of payments received by a hybrid was discussed above at 6.1.4. OECD Figure 11 also illustrates this scenario, but involves the use of three countries.[50] While noting that mismatches in reverse hybrid structures can arise in a bilateral context (as in the extension of Example 2 discussed above at 6.1.4), the Draft justifies the use of a triangular structure by suggesting that 'more commonly the intermediary is established in a different jurisdiction'.[51] While that may be, it fails to highlight the significance of a mismatch structure involving receipt of a payment by a hybrid entity.

As with payments made by hybrid entities, the significance of a mismatch with respect to receipt of a payment by a hybrid entity is that it can be achieved in a bilateral setting. After all, the tax benefits of the structure in OECD Draft Figure 11 can be also achieved by using a non-hybrid entity established in a favourable third country.[52] It may be argued that the state of the payer could unwittingly reduce withholding tax by presuming a tax treaty with the intermediate state applies. But this can be countered with what seems to be the OECD's own position. It seems that a hybrid in such an intermediate state is not 'liable to tax' there and so is not a 'resident' of the intermediate state for tax treaty purposes and the treaty does not apply.[53] The risk with the OECD's unnecessary extension is that tax administrators may think that mismatches arising with respect to receipt of a payment by a hybrid entity only arise in triangular cases.

This causes the OECD Draft to turn (in the same Part) to what it calls 'imported mismatches', which are 'hybrid structures created under the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction'.[54] The connection between 'reverse hybrids' and 'imported mismatches' is not clear, at least from a conceptual perspective.[55] hoppi

state and that a PE may be used in the intermediate state.[57] The Draft contains a Part VII entitled 'Further Technical Discussion and Examples'. This Part is not clearly linked with and the examples used are not categorised by reference to the prior Parts of the Draft. Further, like the discussion of imported mismatches in Part VI, using a PE in a third state raises few issues in addition to those that generally arise when locating a PE in a low tax jurisdiction, especially where the residence state provides foreign tax relief in the form of an exemption.[58]

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However, care must be taken because the detail as to the hybrid element in Table 1 is not consistent with the detailed recommendations in the body of the OECD Draft for Category 1. So, for example, while Table 1 seems to limit the first category by reference to the character of payments, this is not obviously a limitation in the body of the recommendations.[61]

The fourth column in Table 1 incorporates recommendations for changes to the domestic law of countries. These are suggestions for unilateral action. There is some uncertainty as to precisely what is being recommended. For example, it is not clear whether the recommendation to deny a dividend exemption for a deductible payment only applies

double taxation of dividends and controlled foreign corporation ('CFC') rules.[72] It is not clear that countries are as concerned about such accuracy with respect to preventing double taxation. This is evident in domestic rules that cause double taxation, such as the denial of interest deductions for excessive debt (e.g. under earnings stripping rules) without re-characterisation as a dividend qualifying for dividend relief.[73]

The OECD uses no obvious guiding principle in identifying the primary state,[74] although it may be presumed administrative considerations were taken into account. The OECD is adamant that a state applying the rule is not required to 'establish that it has 'lost' tax revenue'.[75] The consequence is that with respect to some of the types of mismatches the state of the payer is the primary state (and gets the tax) and in other cases it is the state of the investor. Further, the allocation does not obviously follow the D/NI or DD types of mismatches. Presuming differences in tax rates in payer and investor states, this leaves scope for gaming between categories of mismatch.

The exceptions to the responses (scope) have the potential to add a substantial layer of complexity to the design and implementation of the recommendations. It is not the purpose of this paper to consider these exceptions in detail. While the exceptions overlap substantially, they are not consistent and so the scope of the exceptions depends on the rule in question and which state is applying it. The drivers for these exceptions seem to be the potential for capturing 'arrangements outside the intended policy' and ability to administer the rules.[76] As at many points the intended policy is unclear, it is difficult to assess when a rule is worth administering more broadly or narrowly and when it is not.

1.3.2 Actions by payer/source/host state

D/NI mismatches for hybrid financial instruments and transfers and hybrid entity payments

In the context of D/NI types of mismatch for both hybrid financial instruments and transfers and hybrid entity payments the OECD recommends that the state of the payer is the primary state. Accordingly, this state will deny the payer a deduction for the payment made that is not included in the income of the recipient. In the context of hybrid financial instruments and transfers, this is subject to the general recommendation that the state of the recipient unilaterally deny a dividend exclusion or exemption for any amount that is deductible in the state of the payer. It seems that this rule is intended to apply in priority to

apply where the investor state offers a different form of dividend relief, such as a lower tax rate or dividend tax credits.[78]

To apply the primary rule in the context of hybrid financial instruments and transfers, the state of the payer must determine whether the recipient is exempt in the investor state. For this purpose, the state of the payer will require information as to the investor's tax affairs of a nature that many countries are not used to asking for. Further, the state of the payer must be satisfied that the exemption is due to the hybrid mismatch arrangement and not, for example, some other status, such as an exemption for non-profit organisations.[79] For this purpose, the OECD proposes a test of whether the mismatch would arise if the arrangement were 'directly entered into between resident taxpayers of ordinary status'.[80] It may be difficult to determine whether a foreign investor is of 'ordinary status' in another state, e.g. what should be compared if two 'ordinary' taxpayers have a different treatment, such as that for individuals and companies?

Further, the payer state adjustment should only be 'to the extent that' the amount is not included in ordinary income.[81] The OECD suggests that the methodology for this apportionment should be left to domestic law, but no guidance or examples are provided.[82] This could be an administratively difficult task, e.g. would the payer state have to consider the potential allocation of expenses in the investor state (such as where the investor is in a loss position there)?

The rule for hybrid entity payments is subject to an additional qualification - a deduction should be allowed to the extent it does 'not exceed the taxpayer's dual-inclusion income for the same period'.[83] This qualification recognises that income will often be subject to tax twice, once in the source state and again in the residence state, and so the expense claimed, e.g. in the source state, can result in greater taxation in the residence state. Accordingly, the rule is targeted at setting the deduction against income that is not included in the other country. To facilitate this qualification, the OECD Draft contains difficult definitions of 'disregarded payment' and 'dual inclusion income'.

Not only are the concepts of 'disregarded payment' and 'dual inclusion income' difficult to understand, but they instil little confidence that they are balanced and robust against abuse.

The exceptions in the payer state for D/NI mismatches with respect to

hybrids and imported mismatches are only to apply to members of a 'controlled group'. This is defined in terms of '50% or more commonality of ownership'.[87] It is not clear whether an individual can b

inclusion income' discussed above at 6.3.2 and, in addition, the definition of 'hybrid payment'. The difficulties of complexity, balance and robustness identified above are again in issue. In addition, an amount for which a deduction is denied should be carried forward for set off against any future dual inclusion income. Further, in the DD case, in a virtual tertiary rule, the investor state should allow a deduction to the extent the taxpayer can show that the payment 'cannot be set-off against the income of any person' in the host state (the 'stranded loss rule').

As for exceptions to these investor state rules, there is less consistency than in the case of payer/host states. The exceptions for D/NI types of mismatch for both hybrid financial instruments and transfers and hybrid entity payments are the same as in the case of the payer/host state, discussed above at 6.3.2, i.e. limited to related parties (including persons acting in concert) and structured arrangements, but excluding widely held instruments and entities. By contrast, in DD types of mismatch for hybrid entity payments and D/NI mismatches for reverse hybrids and imported mismatches (primary rule cases), there are no suggested exceptions.[92]

1.3.4 Actions by intermediate state

Actions by an intermediate state are only relevant in the context of 'imported mismatches'. Here the OECD emphasises the need 'to ensure every jurisdiction adopts effective hybrid mismatch rules'.[93] Specifically, the OECD makes a recommendation that in certain circumstances intermediate states treat hybrid entities as tax residents, especially where that is consistent with the characterisation of the entity in the investor state.[94] This recommendation is limited by qualifications and exclusions, and, as in the case of the payer state, is particularly limited to members of the same control group.

1.4 Other steps that may be taken

The recommendations in the OECD Draft are long, disjointed, complex and difficult to follow, and this discussion has sought to avoid some of the more difficult parts of the Draft.[95] The Draft contains a clear and appropriate set of design principles.[96] However, the recommendations appear to promote few of these. The recommendations are not 'comprehensive' and would not 'minimise the disruption to existing domestic law', 'be clear and transparent in their operation', 'be workable for taxpayers and keep compliance costs to a minimum' or be 'easy for tax authorities to administer'.[97] Further, as noted above at 6.3.1, in the face of other instances of 'double taxation of the same economic income' not addressed by tax treaties,[98] it is not clear why the recommendations must necessarily 'avoid double taxation

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92 For example, see OECD (2014) para. 196.

93 OECD (2014) para. 207. Boidman & Kandev (2014) p. 1244 refer to this as 'plainly utopic'.

94 Paragraph b) of the box at OECD (2014) p. 61.

95 Such as the examples at OECD (2014) paras 237-240, some of which involve situations where two countries disagree on the identity of both the payer and the recipient of a payment.

96 OECD (2014) para. 27.

97 'Foremost among stakeholder concerns during this process has been the fear that administration of the rules and coordination among jurisdictions, as well as with other base erosion and profit-shifting initiatives and domestic law, will be prohibitively difficult, leading to double taxation, competitive inequities, inefficiencies, and impossible compliance burdens.' Athanasiou (2014b) p. 1083.

98 OECD (2014) para. 33.

through rule co-ordination'.[99] The critical thing is to ensure sufficient taxation. Failure to meet the design principles may stem from the OECD attempting to be more targeted and precise than is necessary for this limited purpose.[100]

The OECD recommendations will create interface issues with other domestic rules. For example, the OECD suggests that the hybrid mismatch rules should be applied 'after' general domestic tax base rules 'but before the application of any general non-transaction specific limitation such as a thin capitalisation rule.'[101] These 'non-transaction specific' rules may be more difficult to identify than suggested. Further, rules like these that affect a tax base can play havoc with other rules that apply by reference to the tax base, such as earnings stripping rules, quarantining rules and even rules for limiting the deductibility of charitable donations. In addition, the OECD notes the need for ordering rules as between the recommendations.[102] These are needed because the scope of the rules is not uniform.

The level of coordination required between countries for implementation of the OECD recommendations is unprecedented. The recommendations are prescriptive as to domestic tax law amendments in a manner not seen before. Further, the recommendations require a country to investigate not only the terms -6(h)-1-4(m)m o[(T7(m)- r)-1(m)i a m s(s)-1(s)-1(t)u(e)4(n

developed from separate taxes on the basis of source that were subsequently supplemented with a general tax on the basis of residence. The taxes on source and those on residence were quite distinct.[106] It was from this basis that the first tax treaties evolved, which not surprisingly incorporated a schedular approach.[107] This was not the case in the UK and the US, which had general income taxes. Even though the categorisation of income might have been schedularised, under a general income tax all income of a resident (foreign or domestic) is taxed

tax haven.[108] However, there are other things that a source state will care about. It will be concerned if the investment is substantial or from illegitimate funds. The source state will also wish to make sure that it does not obstruct the free flow of new technology and innovation into its jurisdiction.

Residually and critically, a source state will care (very much) whether its tax system favours foreigners over domestic enterprises in accessing the domestic market. At a minimum, a source state needs to protect the competitiveness of local business in the domestic market. There are things a source state can do to encourage foreigners seeking to access the domestic market to create a more substantial presence (e.g. a PE) that is taxed on a non-discriminatory basis with domestically owned enterprises.[109] Taking action in this direction will also reduce tax benefits from hybrid mismatch arrangements and provide useful context for assessing whether such arrangements are neutralised.

1.4.2 Joint steps: Separating source and residence tax bases

The OECD notes that its recommendations do not require a 'jurisdiction apply the rule to establish that it has 'lost' tax revenue under the arrangement'.[110] This is perceived to be a benefit of the recommendations, but at another level it seems a failure. If the international allocation of taxing rights was more specific, uniform and clear, perhaps it would be obvious whose rights were being eroded by hybrid mismatch arrangements. The tax benefits of many of the examples in the OECD Draft would be thwarted if source country taxing rights were not eroded or denied by tax treaties. Other tax benefits in the examples would be thwarted if residence countries imposed CFC rules, something that to date the OECD has refused to bring into the body of its Model tax treaty (and rather relying on observations in the Commentary). An intermediate jurisdiction is neither the ultimate source state nor the state of the ultimate investor and has little incentive to protect source and residence state tax bases. Fragmentation of investment due to globalisation means that more and more countries find that they are an intermediate jurisdiction in whole or in part.

To protect taxation from hybrid mismatch arrangements, countries need to focus on what they are trying to protect - countries need to identify clearly and distinguish between their source (domestic) and residence (foreign) tax bases. This means more than just identifying the geographical source of income, whether domestic or foreign. A country needs to identify the source of the building blocks that make up income and particularly the source of payments. Some countries do have relatively clear rules on source of income and receipts, though not usually as separate matters. In other countries there are very few rules. What most countries do poorly is specifically identify which expenses can be deducted in calculating domestic source income and which can be deducted in calculating foreign source income. That is, most countries fail to identify the source of expenses and limioD1h(m)ret

ways that were not envisaged when the treaties were concluded. This can create a tax administration resistance for applying such treaties, especially when local service providers are discriminated against. With appropriately selected withholding tax rates, a country can encourage foreign service providers to establish a taxable presence in their jurisdiction (e.g. PE) in order that local expenses can be deducted, i.e. taxation on a net basis.

The OECD Draft makes little reference to withholding tax in its examples and none in its recommendations. It seems that the OECD is not able or willing to reconsider the provisions in its Model tax treaty that facilitate tax base erosion and profit shifting, at least not directly in the context of hybrid mismatch arrangements.[115] While the UN Model tax treaty provides greater scope for protecting source state taxing rights, care still needs to be taken in concluding tax treaties. If a country's representatives are not fully aware of the potential consequences of concluding a tax treaty, the safe option is not to.[116]

The second way to prevent source state tax base erosion is to quarantine foreign expenses. This is the natural consequence of the rule option noted above at 6.4.2 for calculating foreign source income separately from domestic source income. If a payment made by a resident of a state has no source in that state and so the state cannot impose withholding tax then the resident should only be permitted to deduct that expense in calculating foreign source income.[117] This option will protect the state of the investor in some hybrid mismatch arrangements as much as the state of the payer. As demonstrated below at 6.4.5, many of the examples in the OECD Draft involve investors deducting foreign expenses against their domestic source income.[118]

Unlike the OECD recommendations, the effect of the above option is not to deny a deduction and the rule is a uniform rule irrespective of the country of the investor. This is a prime method by which source states can seek to ensure that foreign service providers are not indirectly granted a better tax treatment than local service providers. By contrast, the OECD recommendations seek to cherry pick certain payments for the denial of a deduction. This could be particularly distorting and difficult to administer. OECD recommendations often require that the tax treatment in the payer jurisdiction depend on who holds an investment. Therefore, changes in circumstances of the investor or transfers of an investment (something over which the payer may have no control) may result in a changed tax treatment of the payer (denial of deduction). In turn, this could have a serious impact on the terms and interest rate on which instruments are issued.

At a more extreme level, source states might consider introducing or broadening the scope of their earnings stripping rules. Many countries already have rules that deny a deduction for excessive interest. Some of these are based on transfer pricing (borrowing beyond an arm's length amount), debt to equity ratio (thin capitalisation) or earnings stripping (interest beyond a set proportion of pre-financing expense income) methodology.t Tf Attached

In particular, it is possible to modify an earnings stripping approach to cover all types of base eroding payments. The total of deductions granted for payments made to entities with limited tax liability might be

Problems of favouring foreign investment are dramatically aggravated where expenses pertaining to foreign source income can be set against domestic source income.

to be deducted against domestic source income if

without taxation, perhaps by presuming that Country B will tax, which it will not. Perhaps Country A should treat A as receiving full market value for the sale even if domestically it has a no gain/no loss rule for related party transfers. Sales to residents would always be treated as made at market value, unless the purchased asset falls to be included in the assets of a domestic PE.

The mismatch in Example 5 (timing of payment) would largely (though not entirely) be resolved by aligning comprehensive withholding of tax from the payment with granting a deduction for it. Tax treaties may be interpreted as limiting the ability of a source state (Country A) to withhold tax at the time of accrual (when the deduction is claimed).[129] However, it might be possible to require the payer n e4(t)13-14-2(be2 483.6)3( )2[(r)-5n, Al8sTw 0 -(

largely a timing issue similar to (though not the same as) in Example 5. The comments for Country B with respect to Example 5 equally apply with respect to this version of Example 6.

Country B for the same dividend. In this sense, the example is similar to that in Example 10, discussed below and that discussion is relevant here. In addition, if Country A simultaneously grants A Co a deduction for the dividends as a financing expense it might subject the dividends to comprehensive withholding tax, even though Country B does not see that income and so will not grant a foreign tax credit for the tax.

The mismatch in Figure 3 of the OECD Draft would be addressed in the same manner as the mismatch in Figure 2 except that the comprehensive withholding tax for the deductible financing expenses would be imposed by Country B. Again, it makes little sense for Country B to refund interest withholding tax to B Co and not impose withholding tax on the corresponding manufactured interest payment made by B Co.[132] Further, it makes little sense for Country A to give A Co a foreign tax credit for Country B tax that is credited (and partly refunded) to B Co.

The mismatch in Figure 19 of the OECD Draft would largely be addressed by comprehensive withholding tax in Country A for the deductible financing expense. Beyond that it is hard to comment with respect to the example because it lacks sufficient detail, e.g. as to timing of the deduction for the financing expense, whether A Co receives income from the asset during the term of the repurchase agreement and what amount it receives for the resale under the agreement.

The mismatch in Figure 20 of the OECD Draft results in a mismatch as to the identification and characterisation of a payment. Country A does not recognise the transfer of the shares from A Co to B Co but Country B does. As a consequence, Country B sees two payments (from the distributing company and from B Co to A Co) whereas Country A only sees one (from the distributing company through B Co to A Co). This means that Country A characterises the payment received by A Co as a dividend but Country B sees it as interest paid (B Co having received the dividends). As in Example 6, the cross border mismatch may be addressed through comprehensive withholding tax imposed by Country B on the outbound deductible payment. Further, Country A might deny underlying foreign tax relief for a payment that is deductible, irrespective of whether it considers that it is the payer that is granted the deduction.

largely be addressed as discussed above with respect to that example, by denying dividend relief for deductible payments.

Figure 12 of the OECD Draft is presumed to involve a similar example except three

is because it is a tax haven, it is not clear why the country of the ultimate investor (Country A) is granting foreign tax relief in the form of an exemption for the PE profits. The mismatch would be addressed through comprehensive withholding in the payer state and better targeted foreign tax relief in the investor state.

Figure 13 of the OECD Draft is similar to Figure 11 but involves the use of two intermediary hybrid companies and two payments.The first payment (Borrower Co to B Co Sub) is the same as in Figure 11 and so the discussion of Example 2 is relevant. The second payment (B Co to A Co) is the same as in Example 11 and Figure 9 and so the discussion of Example 11 is relevant. These mismatches would largely be remedied by comprehen

demonstrate that CFC rules should be careful when incorporating an exemption for foreign active business.[137]

worthwhile. For a large number of countries (perhaps a great majority), the cost/benefit analysis may not look proportionate and for countries with struggling tax administrations, implementation may seem impossible.

In any case, as identified above at 6.4, there are other unilateral steps that countries may take to address hybrid mismatch arrangements that are consistent with addressing base erosion and profit shifting more generally. Consistent with the traditional approach to international tax matters, the measures identified that source states may take require no coordination with residence states. The measures identified that residence states may take do require residence states to consider tax treatment in source states, but not to any greater extent than has been usual for the purposes of providing foreign tax relief.

A basic task for countries in considering hybrid mismatch arrangements is to analyse them by reference to the income tax fundamentals of their own system. A country needs to perform this analysis both from the perspective of the country as a source state and separately as a residence state. For this purpose, the country will need to consider very clearly 'what is our source tax?' and 'what is our residence tax?' In addition, it will need to ask whether the tax law currently makes a sufficient distinction between these two taxes. If it does not, the country should consider ways in which it can clarify that distinction.

After identifying whether hybrid mismatch arrangements expose any flaws in the fundamentals of its tax law, a country needs to consider how to respond. The logical and t(n)-10(a)4(s2(ha)e c)4(o8tio4(br(s)-1 m) 2(haeem)-1)-5(t)-6(br(s)-1)-eembl-5(i)44se o8r(s)g(s) ae

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