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ARTICLE

BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements

Reinout de Boer & Otto Marres*

Curbing tax arbitrage is one of the main priorities of the Organization for Economic Cooperation and Development (OECD) (endorsed by the G20 and the G8) ever since the public debate on base erosion fully erupted. Neutralizing the effect of hybrid mismatch arrangements has become Action No. 2 of the OECD Base erosion and profit shifting (BEPS) Action Plan. This has resulted in the recent 2014 deliverable, which is divided into two parts: recommendations for domestic law (part I), and treaty issues (part II). The authors analyse and evaluate the report on the 2014 deliverables on BEPS action point 2. They submit that, given the draw backs of specific anti-hybrid rules as to practical and political feasibility, a further review of alternatives is warranted, particularly with respect to CFC and interest deduction limitations. A more simplified mismatch rule applicable to interest seems particularly worthy of further analysis, given that hybrid mismatch arrangements almost always evolve around interest deduction (a notable exception applies with respect to payments to reverse hybrids; however, effective CFC rules may be effective in countering this particular brand of mismatches). In addition, more generic interest deduction limitations (as opposed to specific hybrid mismatch rules) may be a viable complementary way to mitigate double non-taxation resulting from hybrid mismatches and thus act as a sufficient discouragement for entering into such arrangements.

1 Rise and fall of hybrid mismatch arrangements

The conditions for hybrid mismatch arrangements – disparities in domestic tax legislation – have long been present. However, due to globalization of business, increasing tax competition and perhaps also consolidation of advisory firms, tax planning through the use of hybrid mismatches (also commonly referred to as tax arbitrage) increased dramatically in the past decades. Although in its 2012 report on hybrid mismatch arrangements the Organization for Economic Cooperation and Development (OECD) admits the lack of comprehensive data on the overall tax revenue loss caused by hybrid mismatch arrangements, the available anecdotal evidence shows that the amounts at stake in individual cases are substantial.[1] In US academic literature, a fundamental debate on the merits and deficiencies of tax policies aimed at countering such tax arbitrage has been conducted from 2000 onwards.[2] Proponents of anti-hybrid measures argue that double non-taxation is fundamentally at odds with the international tax system, a basic principle of which would be that cross-border income should be taxed at least once. Opponents take the stance that there is no such thing as a single tax principle; and even if there were, the very nature of hybrid mismatch arrangements – which benefit from at least two tax systems and which operate fully within the scope of each such system – renders it impossible to identify a loser state that should repair the mismatch. Given nations' sovereignty in tax policy, including matters of international taxation, the identification of universal principles in international tax is either an empirical search for common denominators or a theoretical exercise in devising an optimal worldwide tax system. A cynical take might be that only two universal principles apply in international tax: the first principle being that states will take what tax revenue they can get (where possible at the expense of other states through tax competition); the second principle being that taxpayers will pay as little tax as they can (legally) get away with (where possible using aggressive tax planning). Does this imply that each state should be left to fend for itself and that taxpayers should be left unchecked in their quest for minimizing tax expense? A pragmatist's answer – even one without an

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1 OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues,* OECD, Paris (the '2012 OECD Hybrids Report').

2 See for example H.D. Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the 'International Tax System'*, 53 Tax L. Rev. 137 et seq. (2000); R.S. Avi-Yonah, *Commentary on Rosenbloom, International Tax Arbitrage and the 'International Tax System'*, 53 Tax L. Rev. 167 et seq. (2000); and R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage and the International Tax Regimes*, 61 BIT 130 et seq. (2007).

all-encompassing vision on worldwide taxation – would be that unfettered tax competition in the end harms all states and that states are thus well advised to coordinate to try and round the sharp edges of tax competition. On the same token, taxpayers should not engage in tax planning that eventually is harmful to themselves, for example where their tax planning puts the infrastructure from which they benefit at risk or where their tax planning alienates customers and business partners.

Individual states have sought to counter hybrid mismatch arrangements through a diverging range of measures.[3] The criticism levelled at these individual states' efforts echoes the cynic's outlook on international taxation: why risk a negative impact on the investment climate by being (among) the first to introduce anti-hybrid measures, particularly where taxpayers have plenty of options – here or abroad – to restructure to still obtain the same or similar tax benefits?[4] The obvious response to these questions is to try and find consensus on a coordinated response to tax arbitrage among a meaningful number of states. And indeed, curbing tax arbitrage has become an important aim of the EU and the OECD (endorsed by the G20 and the G8) in the project to counter base erosion.

Already in 2010, the EU Code of Conduct Group on Business Taxation reported to the Economic and Financial Affairs (ECOFIN) Council on hybrid financial instruments and advised that participation exemptions should not extend to payments treated as deductible in the source state.[5] This recommendation has led to the adoption by the ECOFIN Council in July 2014 of a corresponding amendment to the EU Parent-Subsidiary Directive, providing that EU Member States should not at parent level exempt a profit distribution that was deductible by the subsidiary.[6] The EU Code of Conduct Group extended its work to hybrid entities and hybrid permanent establishments. The preparatory technical work of identifying the issues and formulating potential solutions is done in a designated sub-group of the Code of Conduct Group.[7] The OECD has derived guidance from the work of this sub-group in drafting its work on Action 2.[8]

In early 2012, the EU Commission issued a consultation document on double non-taxation, with particular interest to hybrid mismatch arrangements.[9] Within the same week, the OECD published a report on double non hybrid mismatch arrangements, even before the term BEPS was coined. This was followed by the publication of the EU action plan on aggressive tax planning in December 2012[10] and the OECD's February 2013 report identifying 'key pressure areas' for further work on base erosion and profit shifting.[11] Neutralizing the effect of HMAs has become Action No. 2 of the OECD BEPS Action Plan.[12] In March 2014, the OECD published public discussion drafts of the recommendations for Action 2.[13] Responses to this consultation were published in May this year[14] and this has resulted in the recent 2014 deliverable, which is divided into two parts: recommendations for domestic law (part I), and treaty issues (part II). The report has been welcomed by the G20 Finance Ministers at their meeting in Cairns, Australia, on 20 and 21 September last.[15] The clear goal of the efforts of the EU and the OECD in the area of HMAs is to add a new 'common denominator' to international taxation, namely that states should not accept and should not facilitate HMAs resulting in double non-taxation.

In this contribution we will analyse and evaluate the report on the 2014 deliverables on BEPS action point 2 (hereinafter: the Report).[16]

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3 The 2012 OECD Hybrids Reports for example refers to specific measures implemented in New Zealand, the United Kingdom, the United States, Denmark, Austria and Italy.

4 See for instance, Jakob Bundgaard, Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage – The Case of Hybrid Entities and Hybrid Financial Instruments, BIT 2013 (Vol. 67), No. 4/5, at 5, where the author expresses the fear that Denmark might lose foreign direct investment as a result of the introduction of anti-hybrid rules.

5 Code of Conduct Group Progress Report of 25 May 2010, doc. 10033/10, para. 31.

6 Council Directive 2011/96/EU of 30 Nov. 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8, as amended per ECOFIN Council 8 Jul. 2014 (OJ L 219/40, 25.7.2014).

7 Reinout de Boer and Martijn Nouwen (ed.), *The European Union's Struggle with Mismatches and Aggressive Tax Planning*, Report of the Amsterdam Centre for Tax Law (ACTL) Conference held in Amsterdam on 5 Apr. 2013, Eleven International Publishing 2013, Ch. 8.

8 OECD (2014), *Public Discussion draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* ('2014 OECD Consultation on Recommendations for Domestic Laws'), at 7.

9 European Commission, Summary Report of the Responses Received on the Public Consultation on Factual and Possible Ways to Tackle Double Non-Taxation Cases (5 Jul. 2012), TAXUD D1 D(2012).

10 European Commission, An Action Plan to strengthen the fight against tax fraud and tax evasion, COM(2012) 722 final (6 Dec. 2012), at 6.

11 OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing.

12 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Action 2 – Neutralise the effects of hybrid mismatch arrangements, at 15–16.

13 2014 OECD Consultation on Recommendations for Domestic Laws; and OECD (2014), *Public Discussion draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* ('2014 OECD Consultation on Treaty Issues').

14 OECD (2014), *Comments received on Public Discussion drafts BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements.*

15 For the communiqué, see: https://www.g20.org/sites/default/files/g20_resources/library/Communique%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Cairns.pdf.

16 OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

2 The OECD's strategy for the neutralization of hybrid mismatches

Before discussing the recommendations in more detail, it is worth briefly discussing the strategy of the OECD in devising these measures. This should be helpful to understand the intended scope of the measures (in below sections 3. and 4.) and also provides a framework for critical analysis (in section 5.).

2.1 *Analysis of the Strategy*

The OECD's strategy for countering mismatches is defined through answering seven basic questions: (1) Which cases of double non-taxation caused by hybrid mismatches should be tackled and why (*problem definition*)?; (2) Which are the possible routes to tackle the problem and which approach is the preferred one?; (3) What should the *material scope* of concrete anti-hybrid measures be?; (4) What should the *personal scope* of the anti-hybrid measures be?; (5) To which general design principles should anti-hybrid rules be held?; (6) How do the recommended anti-hybrid measures relate to other elements of the OECD Action Plan?; and (7) How to implement the recommendations in practice?

2.2 *Problem Definition: Focus on D/NI and DD*

A key issue identified in the OECD BEPS project is that domestic corporate income tax systems have not kept pace with the development of international, cross-border economic activity. In the OECD's words: 'the interconnectedness of domestic economies has highlighted the gaps that can be created by interactions between domestic tax laws'.[17] The OECD has found that these 'gaps' are exploited through hybrid mismatch arrangements, which can be used to achieve unintended double non-taxation or long-term tax deferral. The Report defines a hybrid mismatch arrangement as an 'arrangement that exploits the difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to that arrangement'.[18] According to the OECD, the two quintessential hybrid mismatch arrangements are: (i) payments that are deductible under the rules of the jurisdiction of the payer and not included in the income of the recipient (so called *deduction / no inclusion* or '**D/NI**' outcomes) and (ii) payments that give rise to duplicate deductions from the same expenditure (a *double deduction* or '**DD**' outcome). In addition, the OECD points to mismatches that are used to create (excess) *foreign tax credit* or that exploit participation exemption regimes. Accordingly, the Report focuses on cross-border mismatches resulting in D/NI and DD.

2.3 *Choice from Available Solutions: From General Anti-avoidance Rule to Targeted Anti-hybrid Rules*

In its 2012 Hybrids Report, the OECD identified four policy options to neutralize hybrid mismatch arrangements: (a) harmonization of domestic laws; (b) general anti-avoidance rules; (c) specific anti-avoidance rules; and (d) rules specifically addressing hybrid mismatch arrangements. The OECD discards the harmonization option for lack of political feasibility – this testifies to pragmatism on the part of the OECD.[19] General anti-avoidance rules generally require that an arrangement is aimed at avoiding tax in the jurisdiction applying the rule. However, hybrid mismatch arrangements tend to comply with domestic law and would therefore likely not fall under the scope of general anti-avoidance rules, which are therefore not deemed to be suitable by the OECD to counter mismatches.[20] Item (c) refers to specific domestic anti-avoidance rules that, although they are not specifically or exclusively targeted at hybrid mismatch arrangements, may work to neutralize such arrangements – for instance rules that for the deduction of a payment require minimum taxation of such payment at the recipient or rules that deny a specific tax benefit (e.g., a deduction) where the arrangement is set up primarily with the aim of obtaining such benefit. Item (d) refers to measures targeted specifically at hybrid mismatch arrangements.

The 2012 Hybrids Report recommends revising or introducing specific and targeted rules denying benefits of hybrid mismatch arrangements. In keeping with this recommendation, the 2013 OECD Action Plan calls for development of targeted and specific domestic rules to neutralize hybrid mismatch arrangements. More specifically, the 2013 OECD Action Plan asks for recommendations for the design of: (i) domestic law provisions that prevent exemption or non-recognition for

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17 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, at 15.

18 Report, para. 41, at 29.

19 2012 OECD Hybrids Report, at 13. Reference can also be made to the lukewarm response to the EU CCCTB project, which has appeared, at the least for the moment, to have come to a grinding halt.

20 See also 2012 OECD Hybrids Report, at 13.

payments that are deductible by the payer; (ii) 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); and (iii) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction. The Report sticks closely to the 2013 OECD Action Plan and aims to devise specific rules, targeted exclusively at hybrid mismatch arrangements (referring to arrangements containing a hybrid element, i.e. a different characterization in two or more jurisdictions) resulting in D/NI or DD. The Report does not elaborate on the potential of specific anti-avoidance rules (e.g., interest deduction limitations) that are *not* exclusively targeted at hybrid mismatch arrangements for neutralizing such arrangements and the Report does not deal with the question to which extent such rules might obviate the need for exclusive anti-hybrid rules.[21]

Notwithstanding the Report's focus on measures aimed specifically at hybrid mismatches, the OECD finds that mismatches may be caused by certain basic flaws in domestic laws, rather than result from hybrid elements in transactions. In those cases, the OECD recommends to also mend these basic flaws. The reparation of such omissions may solve the mismatch and specific anti-hybrid measures need then not be applied. An example is the mitigation of unintended double non-taxation caused by the effective exemption of dividend income from qualifying participations. Another example is the introduction or enhancement of CFC rules in the residence state of the investor in order to effectively reverse D/NI outcomes. The general background for such exemption is the desire to avoid or mitigate economic double taxation of dividends. However, where dividend payments are deductible in the source state, exemption of the dividends in the residence state of the parent company should not be required, as taxation of such income would not create economic double taxation. This is precisely the thought behind the recent amendment to the EU Parent-Subsidiary Directive. Thus, conceptually, the reparation of such basic flaws is the first step in addressing hybrid mismatch arrangements.

2.4 *Material Scope of Anti-hybrid Measures*

The 2012 Hybrids Report already defined the basic (hybrid) elements of hybrid mismatch arrangements and their effects – hybrid instruments, hybrid entities, dual residence entities and hybrid transfers, resulting in deduction / no inclusion, double deduction or the creation of (excess) foreign tax credit. The Report – and notably also the 2014 OECD Consultation on Recommendations for Domestic Laws – further refines and extends this analysis, by giving more and more detailed examples of the basic arrangements identified in the 2012 Hybrids Report and by also including *reverse hybrids* and cases of *imported mismatches* (the latter category generally combining several basic hybrid elements and using a third jurisdiction through which the hybrid element is 'imported').

In drafting the anti-hybrid rules, the OECD follows a *three-step* approach. As a first step, it seeks to mend certain perceived basic flaws in domestic law that are prone to create opportunities for use of hybrid mismatch arrangement. An example of such flaw would be granting an exemption of income in the residence state – which exemption exists to mitigate economic double taxation – where no economic double taxation occurs due to deductibility of the relevant payment in the source state. The scope of such 'reparation' measures is not limited to hybrid mismatch arrangements. A second step is to provide for a primary (linking) rule denying relevant beneficial tax treatment in one of the states involved in a specific hybrid mismatch arrangement. In essence, the state to implement the primary rule should be the state to which – under general principles of international tax law- the first right to tax the relevant income is attributed ('first bite at the apple' principle[22]). This principle generally implies that the right to tax active income is in first instance attributed to the source state and that the primary right to tax passive income falls to the residence state of the investor. As a third step, the OECD devises a secondary, defensive (linking) rule to be implemented by one of the other jurisdictions, to be applied where the primary rule is not implemented or used.

The approach of the OECD in drafting the linking rules is to infer general characteristics from individual cases in terms of their structuring and their effects and to then devise a comprehensive rule that covers these cases and also similar situations that bear the same hallmarks. To this end, in the recommended measures hybrid mismatch arrangements are primarily defined in terms of their *effect*.

In devising the recommended rules, the OECD acknowledges that it has had to reckon with the realities of international taxation – namely lack of agreement between states on the principal course, or, to the extent that states would agree on a common approach lack of

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21 The Report does include the following general statement (at 64): 'It is also recognised that the outputs from other Actions may have an effect on the intended outcomes under the hybrid mismatch rules. For example if a jurisdiction were to adopt a broad interest limitation measure; limiting the amount of interest that is deductible by a domestic group to a proportion of the interest paid by the worldwide group, it may no longer need the hybrid financial instrument rule to adjust the tax outcomes for members of a controlled group (although it may still need rules to tackle structured arrangements and financial instruments that are entered into outside of the group).'

22 E.g., reference to *Avi-Yonah* (International Tax as International Law: An Analysis of the International Tax System, at 26), describing the rule adopted by the League of Nations in 1923: 'Under that rules, the source (territorial) jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit.'

uniformity in legislative measures and the interpretation and execution thereof. The working assumption of the Report is that all states would adopt the recommendations – if the rules would only be adopted by a limited number of states, mismatch opportunities would continue to abound. However, the proposal for secondary, defensive (linking) rules illustrates the OECD's awareness that worldwide adoption may be illusory. The second assumption is that measures taken by individual states – if based on the format recommended by the OECD – would effectively eradicate hybrid mismatch arrangements. The suggestion for tiebreaker rules, which become relevant where both the primary and secondary rules are applied simultaneously, illustrate the OECD's pragmatism in this respect.

The 2014 OECD Consultation on Recommendations for Domestic Laws also discussed the need for an exception from the hybrid mismatch rules for *traded instruments*, primarily due to difficulty for the issuer to stay informed of the identity of successive holders and their tax treatment. However, a categorical exclusion of traded instruments would be considered an open invitation to circumvent the hybrid mismatch rules. The 2014 OECD Consultation on Recommendations for Domestic Laws therefore noted the necessity of including traded instruments within the scope of hybrid mismatch rules where such instruments are part of structured arrangement designed to create or use a mismatch. Accordingly, the Report does not foresee a categorical exclusion of traded instruments.

Another issue regarding material scope addressed in the 2014 OECD Consultation on Recommendations for Domestic Laws is how to deal with *hybrid regulatory capital*. Both the Consultation and responses to the Consultation from the financial sector[23] note that the use of hybrid regulatory capital – also intra-group – stems from regulatory requirements and is not induced by taxation. The responses from the financial sector suggest that the application of linking rules to hybrid regulatory capital might have unwarranted consequences, particularly for hybrid regulatory capital issued intra-group to meet local capital requirements, where the resulting taxation (through denial of deduction) negatively affects the required capital.[24] Nonetheless, the tax treatment of such capital diverges among jurisdiction, which may cause hybrid mismatches. A suggestion made in the Consultation is the introduction of a 'co-ordination rule which would allow the tax effect of the issuer's deduction to be passed down chains of related parties to the ultimate borrower'. The Report proposes that the concerns on hybrid regulatory capital are further explored to see if a special treatment under the hybrid mismatch rules is justified. The OECD will seek guidance from stakeholders, including the Financial Stability Board on hybrid regulatory capital, and process such guidance in the Commentary.

2.5 *Personal Scope of Anti-hybrid Measures*

The 2014 OECD Consultation on Recommendations for Domestic Laws proposed a choice (at least for hybrid financial instruments and transfers) between a *bottom-up* approach – with a primary focus on defining which mismatches to *include* in the scope – and a *top-down* approach– with primary focus on defining which structure to *exclude* from the scope of the linking rules.[25] According to the OECD, the overall outcome of each approach should be the same, in that linking rules should in any case apply to instruments held by *related parties* (including persons acting in concert) and to *structured arrangements* designed to produce a mismatch. The 2014 OECD Consultation on Recommendations for Domestic Laws recommended that the hybrid financial instrument rule should not apply to widely held instruments, i.e. instruments that are typically offered to the public and that are held by a large number of holders across a wide range of jurisdictions. From an issuer's perspective, an exception for widely held instruments would be necessary, as an issuer may – except for related party situations – not be in a position to verify the tax treatment of holders of the instrument. *Vice versa*, the holder of a widely held instrument may encounter less practical difficulty in verifying the tax treatment of (payments under) the instrument at the level of the issue; however at present there are as a rule no reporting mechanisms in place to keep the holders of widely held instruments up to date on the issuer's tax treatment.

In line with the Consultation and the response thereto, the Report takes a bottom-up approach with respect to D/NI mismatches and recommends to limit the scope of specific linking rules for *hybrid financial instruments* to *related parties* and *structured arrangements*. In the same vein, the anti-hybrid mismatch rules proposed to counter *disregarded payments by a hybrid*, *payments made to a reverse hybrid* and *imported mismatches* (each a D/NI mismatch) are limited to (members of a) controlled group and structured arrangements. For DD mismatches, the Report proposes no restriction in personal scope (an exception applies to

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23 See for instance the comments from the European Banking Association (EBA), as published in Comments received on Public Discussion drafts, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements, 7 May 2014 (OECD, 2014), at 188–190.

24 See for instance the comments from the Banking and Finance Company Working Group on BEPS, as published in Comments received on Public Discussion drafts, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements, 7 May 2014 (OECD, 2014), at 54–57.

25 2014 OECD Consultation on Recommendations for Domestic Laws, at. 32–42.

the defensive rule – deny payer deduction – for *deductible payments made by a hybrid*, which is limited to controlled groups and structured arrangements).

The Report finds that hybrid mismatches through financial instruments or hybrid transfers between *related parties* (or persons acting in concert) will in practice have been intended and that, should a mismatch between related parties arise by chance rather than intention, related parties would be able to among themselves come to a mutually satisfactory allocation of risks and costs from anti-hybrid rules. The Report sets a standard of 25% direct or indirect (common) ownership for parties to qualify as 'related' for purposes of the hybrid mismatch rules.[26] The Consultation had in first instance suggested to set the threshold at 10%, however, the responses to the Consultation – indicating that the 10% bar would be over-inclusive – have convinced the OECD to raise the threshold to 25%.

For parties to form part of a *controlled group* or *control group,* the Report sets a commonality of ownership of 50% or more (including persons acting in concert). 2014 OECD Consultation on Recommendations for Domestic Laws explains the limitation to limit the personal scope of hybrid mismatch rules to a control group as follows: 'Provided the payer, intermediary and investor are all members of the same control group (i.e., 50% or more commonality of ownership including persons acting in concert) it should be a relatively simple matter for one party to the arrangement to determine the other parties' tax treatment on the same payment'.[27]

The reason why the Report distinguishes between a related party threshold of 25% for hybrid financial instruments and transfers and a controlled group threshold of 50% for other D/NI mismatches, may be that in the case of hybrid financial instruments or transfers the hybrid element pertains to the *instrument* itself and parties to such instrument may be deemed to be aware of the resulting mismatch (which justifies a lower threshold to imply intent), whereas other D/NI arrangements rely (also) on the use of hybrid *entities* and a higher threshold of common ownership would be required to imply knowledge of this hybrid element at the level of the parties to the arrangement.

As regards DD mismatch arrangements, the double deduction of expenses by the payer thereof is not dependent on the (hybrid) status of the payee or the instrument to which payer and payee are party and it would therefore indeed make sense to in principle not apply a related party or controlled group threshold for the hybrid mismatch rules.

The restrictions in scope to related parties and control groups have been proposed to avoid that the hybrid mismatch rules would be overly broad and to thus avoid undue complexity in the application and administration thereof. If the required thresholds of common ownership are met, the Report proposes automatic application of the hybrid mismatch rules. However, the sole use of fixed, objective thresholds would easily allow taxpayers to circumvent the hybrid mismatch rules. Therefore, the Report proposes to extend the scope of hybrid mismatch rules to 'structured arrangements'. The Report defines a structured arrangement as 'any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch'.[28] The Report contains a list of specific examples of structured arrangements engineered to produce a mismatch.[29]

2.6 *General Design Principles*

According to the Report, the hybrid mismatch rules should meet certain criteria for 'good rule design'. In particular, the rules should:

> (a) operate to eliminate the mismatch without requiring the jurisdiction applying the rule to establish that it has 'lost' tax revenue under the arrangement; (b) be comprehensive; (c) apply automatically; (d) avoid double taxation through rule co-ordination; (e) minimise the disruption to existing domestic law; (f) be clear and transparent in their operation; (g) facilitate co-ordination with the counterparty jurisdiction while

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26 Report, Recommendation 11., 'Definition of Related Persons, Control Group and Acting Together', at 69: '(a) Two persons are relate if they are in the same control group or the first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both. (b) persons are in the same control group if: - they are consolidated for accounting purposes; - the first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provides that person with effective control over both persons; - the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or - the can be regarded as associated enterprises under Article 9 [of the OECD Model Convention]. (c) A person will be treated as holding a percentage investment in another person if that person holds directly or indirectly through an investment in other persons, a percentage of the voting rights of that person or of the value of any equity interests of that person.'

27 2014 OECD Consultation on Recommendations for Domestic Laws, para. 233, at 65.

28 Report, Recommendation 10., item 1, 'Definition of Structured Arrangement', at 67.

29 Report, Recommendation 10., item, 2, 'Specific Examples of Structured Arrangements', at 68: 'Facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following: (a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch; (b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch; (c) an arrangement that is marketed, in whole or in part, as a tax advantage product where some or all of the tax advantage derives from the hybrid mismatch; (d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises; (e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available; or (f) an arrangement that would produce a negative return absent the hybrid mismatch.'

providing the flexibility necessary for the rule to be incorporated into the laws of each jurisdiction; (h) be workable for taxpayers and keep compliance costs to a minimum; and (i) be easy for tax authorities to administer.[30]

It should be noted that the OECD's strategy seems to be primarily aimed at *discouragement* of mismatch arrangements and to 'drive taxpayers towards less complicated and more transparent cross-border investment structures',[31] rather than seeking an optimal solution (for instance from the perspective of economic efficiency or that of administrative feasibility) when redressing the effects of individual cases of mismatches. This may imply that the OECD prioritizes that the anti-hybrid rules are clear and comprehensive and accepts administrative complexity inherent to such all-encompassing rules, on the assumption that in practice the rules would not need to be applied due to taxpayers no longer using targeted hybrid mismatch arrangements.

2.7 *Relation of Anti-hybrid Measures with Other Items from the Action Plan*

The 2013 Action Plan makes clear that the work on hybrid mismatch arrangements should be coordinated with other Actions:

> 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.

The timing for publication of the Actions on interest deductions and CFC rules is September 2015. The Report does not comment extensively on the relation with interest deduction and CFC Actions, although it notes the need for coordination and also recognizes that the result from other Actions may have effects on the outcome of hybrid mismatch rules (e.g., where a general interest deduction limitation would mitigate the mismatch).[32] The OECD website states the following:

> These recommendations may be impacted by decisions taken with respect to the remaining elements of the BEPS Action Plan, which are scheduled to be presented to G20 Governments for final approval in 2015. At that point Governments will also address implementation measures for the Action Plan as a whole.

2.8 *Implementation and Coordination of Recommendations*

The Report admits that the proof of the pudding is in the eating and that coordination between jurisdiction of timing and consistency of hybrid mismatch rules is a necessity for the recommendations to be effective. The Report contains a list of recommendations on implementation and coordination.[33] The list illustrates that a lot of work is still to be done before the broad and uniform application of hybrid mismatch rules is a fact. The OECD and the G20 commit to provide guidance on implementation and coordination items in Commentary to be issued ultimately in September 2015.[34]

2.9 *Summary*

The OECD's strategy to tackle hybrid mismatch arrangements can be summarized as follows:

– The recommendations in the Report focus on DD and D/NI caused by arrangements containing a hybrid element.

– Conceptually, the primary solution proposed by the OECD to tackle these mismatches is to mend certain basic flaws in domestic law that are liable to cause the mismatches. These reparations have no limitation in scope.

– Secondly, the Report recommends the widespread introduction of targeted linking rules that apply automatically. The Report distinguishes between primary and defensive rules. As a rule, the primary linking rule is to be applied by the jurisdiction that under international tax law could be considered the state that should be allowed to tax the relevant income. The aim and scope of the linking rules are limited to redressing the double non-taxation resulting from the

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30 Report, Ch. 5, Recommendation 9., item 1, 'Design principles', at 64.

31 Report, para. 11, at. 13.

32 Report, paras 116 and 117, at 64.

33 Report, Recommendation 9., at 65: 'Jurisdictions should co-operate on measures to ensure these recommendations are implemented and applied consistently and effectively. These measures should include: (a) the development of agreed guidance on the recommendations; (b) the co-ordination of the implementation of the recommendations (including timing); (c) development of transitional rules (without any presumption as to grandfathering of existing arrangements; (d) review of the effective and consistent implementation of the recommendations; (e) exchange of information on the jurisdiction treatment of hybrid financial instruments and hybrid entities; (f) endeavouring to make relevant information available to taxpayers (including reasonable endeavours by the OECD); and (g) consideration of the interaction of the recommendations with other actions under the BEPS Action Plan including Actions 3 and 4.'

34 Report, para. 114, at 63.

mismatch and to align the tax treatment of the relevant hybrid element in the jurisdictions.

- The material scope of the recommended hybrid mismatch rules is not confined to one type of income, but covers interest, as well as royalty, rent and other considerations. In practice, however, the measures are targeted in large part at interest payments (we refer to our analysis in section 3 below).
- Recognizing the difficulty in applying and administering overly broad hybrid mismatch rules, the Report chooses to limit the personal of the recommended hybrid mismatch for D/NI arrangements to related party, controlled group situations and structured arrangements.
- Implementation and coordination issues and the relation with other Actions are to be sorted later – to start with, the OECD intends to publish a detailed Commentary in the course of 2015. In this respect the Report's findings and recommendations are still provisional.

3 Recommendations for domestic laws

3.1 *Arrangements that Produce D/NI Outcomes*

The Report distinguishes three main categories of arrangements that produce D/NI outcomes:

- Hybrid financial instruments and hybrid transfers (Recommendation 1. and Recommendation 2. in the Report pertain to these mismatches).
- Disregarded payments made by a hybrid entity to a related party (Recommendation 3. in the Report).
- Reverse hybrids (covered by Recommendation 4. and 5. in the Report).

3.1.1 *Hybrid Financial Instruments and Hybrid Transfers*

The Report generally defines a *hybrid financial instrument* as 'any financing arrangement that is subject to a different tax characterization under the law of two or more jurisdictions such that a payment under the instrument gives rise to a mismatch in tax outcomes'.[35] The terms 'financing arrangement' and 'financial instrument' seem to be exchangeable and – according to the OECD – would in any case refer to 'anything that is treated as a debt or equity' under the laws of a jurisdiction involved in the arrangement and should also include 'arrangements that taxpayers use as alternatives to debt and equity'.[36] For purposes of the Report, the term hybrid financial instruments includes *hybrid transfers*. In the Report, a *hybrid transfer* is described as 'a particular type of collateralised loan arrangement or derivative transaction where the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of the loan collateral or subject matter of the derivative'.[37] Here the mismatch does not stem from the fact that there is a *different* characterization of an instrument or payment, but from the fact that the jurisdictions involved award the *same* or *similar* tax treatment to the perceived owners of an asset.

The 2014 OECD Consultation on Recommendations for Domestic Laws gave a number of examples of hybrid financial instruments. A distinction can be made between cases where the difference in tax characterization pertains to the *instrument* itself on the one hand and cases where the difference in tax characterization (or rather: treatment) regards the (interest) *payments* on the instruments on the other hand. Below Figure 1. (Basic Hybrid Financial Instrument – Figure 2.1 from the Report) represents an example of the first category. An example of the second category is an optional convertible note.[38]

The example Figure 1. concerns a (hybrid) financial instrument that – for domestic tax law purposes – is treated as equity in Country A and as debt in Country B. Country B allows for deduction of interest payments on the instrument at the level of the issuer, B Co, whereas Country A provides for effective tax relief on such income at the level A Co. (e.g., through an exemption). The OECD takes issue with hybrid financial instruments because these arrangements are subject to different tax characterizations in the respective jurisdictions involved (this would be the *hybrid* element), which leads to a 'mismatch' in tax outcomes. In the examples given in Figure 1. and 2. this mismatch consists of an interest *deduction* in Country B, while *no inclusion* of corresponding (interest) income occurs in the taxable base of the holder of the financial instrument in Country A – the OECD refers to this type of mismatches as D/NI.

Notes

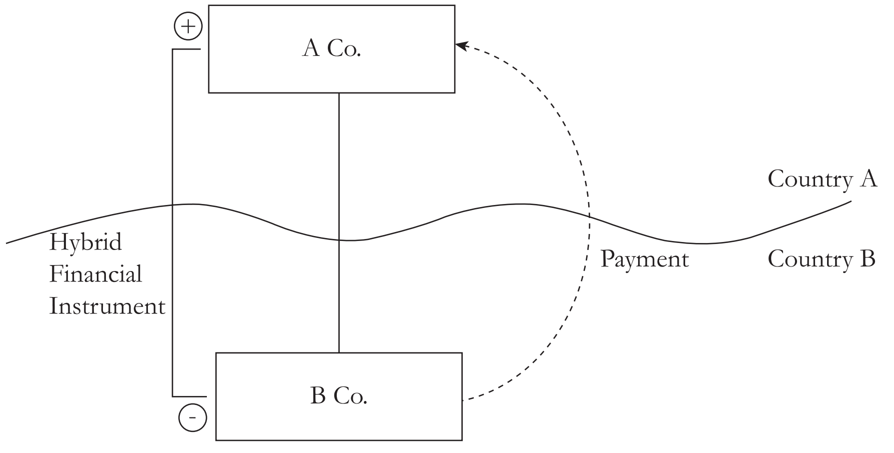
35 Report, at 33.

36 2014 OECD Consultation on Recommendations for Domestic Laws, at 25.

37 Report, para. 55., at 34.

38 Report, para. 54, at 34. Other examples are included in the 2014 OECD Consultation on Recommendations for Domestic Laws, notably in para. 64, at 20.

Figure 1 Basic Hybrid Financial Instrument – Different Characterization of Instrument[39]



The following example derived from the Report illustrates a *hybrid transfer*.

Figure 2 Collateralized Loan Repo[40]

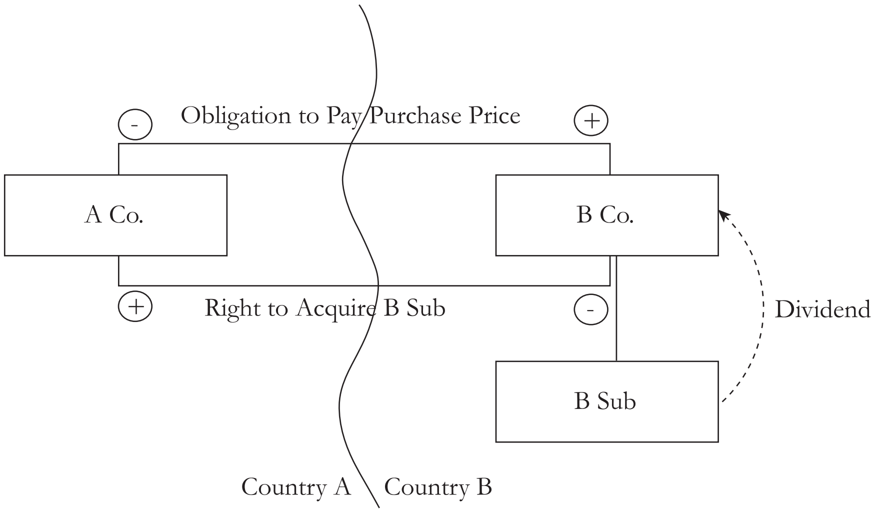


Figure 2. (also dubbed 'foreign tax credit generator') represents an example of a common transaction used to produce a mismatch in tax outcomes through hybrid transfers. Here, A Co sells and transfers the shares in B Sub to B Co, with B Co actually paying the purchase price to A Co, while arranging that A Co will re-acquire the share at a determined future dated for a set price. During the intermittent period between initial sale and repurchase, B Sub continues its business and distributes its after tax profits as dividends to B Co (assume in this example a B Sub profit of 100 and a tax rate of 30%, leaving B Sub with an after tax profit of 70 which it distributes to B Co).

Country B treats the transaction according to its *form* and treats B Co as the owner of B Co and as the beneficial owner of the dividends. Country B exempts the dividends paid by B Sub to B Co from both from withholding tax and from corporate income tax. Contrary to country B., Country A treats the transactions in line with its *substance*. This implies that it treats the arrangement between A Co and B Co as a loan from B Co to A Co, which in turn implies deduction of the interest element effectively paid to B Co (assume that this deductible interest is 70, equal to amount of the dividend payment of B Sub to B Co). Country A treats A Co as the (beneficial) owner of B Sub and the dividends paid by B Sub and allows A Co to claim a credit for underlying foreign tax of 30. A Co's net taxable profit is calculated at 30 (100 – i.e., dividend of 70 plus foreign tax credit of 30 – minus 70 – i.e., the construed interest payment to B Co). Assuming a tax rate

Notes

39 Report, Figure 2.1.

40 Report, Figure 2.2.

of 30%, this leads to a tax payable of 9. Offsetting the foreign tax credit of 30, this results in an (excess) net foreign tax credit of 21 for A Co. While the effect of this arrangement is the creation of an excess foreign tax credit, it operates through creation of a deductible interest payment at A Co level, with no inclusion of such interest payment in the tax base of B Co – this amounts to a D/NI mismatch.

The 2014 OECD Consultation on Recommendations for Domestic Laws also mentioned other examples of hybrid transfers: a bond lending repo (which also creates excess tax credit through a 'manufactured' interest payment, however without being the product of a D/NI mismatch),[41] a collateralized loan repo utilizing a tax exemption (which creates a D/NI outcome through deduction of the repurchase premium by the repurchasing entity, where such premium is exempt in the hands of the recipient)[42] and a share lending repo (which may be used to create a D/NI mismatch: deduction of a manufactured divided paid by the stock borrower and effective exemption of such payment with the stock lender).[43] A share lending repo is also a widely used instrument for securities traders to hedge exposure on shares or to gain exposure on the relevant stock, without a specific tax purpose.

An essential element in both hybrid financial instruments and hybrid transfers is that they concern the deduction of (construed) interest.

The solution proposed by the OECD to address the mismatch resulting from hybrid financial instruments and hybrid transfers consists of two separate elements: (i) the introduction of specific 'linking' rules addressing targeted hybrid financial instruments (Report, Recommendation 1. – Hybrid financial instrument rule, at 37–39); and (ii) proposals for reparations to domestic tax law applicable to financial instruments that may also target *hybrid* financial instruments (Report, Recommendation 2. – Specific recommendations for the tax treatment of financial instruments, at 41). Conceptually, the domestic law reparations take precedence, as they may obviate the need for the application of linking rules in certain cases.

– Specific recommendations for the tax treatment of financial instruments (domestic law)

Denial of dividend exemption for deductible payments

The recommendation here is for jurisdictions that apply a tax exemption for (qualifying) dividends – e.g., under a participation exemption regime – to disallow such exemption to the extent that the dividend payment is deductible in the jurisdiction of the issuer. The policy rationale for this recommendation is that dividend exemptions have been introduced to mitigate double economic taxation – i.e. the taxation of the same income in the hands of more than one taxpayer. Where a dividend payment is deductible for the issuer of the financial instrument, arguably no such double economic taxation occurs and there would thus be no reason to exempt the dividend payments in the hands of the recipient. Implementation of this rule would imply that in the above example in Figure 1. – the basic hybrid loan arrangement – Country A would deny the domestic dividend exemption to the holder of the instrument.

The Report sees no reason to apply any qualification as to scope with respect to the proposed denial of dividend exemptions for deductible dividend payments and this measure would not need to be targeted specifically at hybrid arrangements. Where a dividend payment is deductible, economic double taxation does simply not occur and there would thus be no reason to apply a dividend exemption. In addition, as the dividend exemption is a diversion of the main rule – namely to include income in the tax base of an ordinary taxpayer – tax administrations may require taxpayers claiming the exemption to prove that they are eligible for the exemption, rather than requiring of the tax administration to only deny the exemption when a specific hybrid financial instrument is used.

Limitation of tax credits for tax withheld at source

This second domestic law recommendation proposes that countries that grant a tax credit for source taxation, would only do so to in proportion to the net taxable income of the relevant taxpayer. Such general tax credit limitation would, according to the Report, serve to prevent the duplication of tax credits under hybrid transfers. Also here, the Report suggests no limitation in scope.

– Introduction of specific linking rules

The above denial of dividend exemptions to be introduced in domestic tax laws may prove effective to counter a substantial part of mismatches through hybrid financial instruments. For situations where mismatches would still occur, the OECD Recommendation recommends the introduction of specific linking rules in domestic law: a *primary* linking rule for the source state (the state of the issuer of the financial instrument) and a secondary, or *defensive*, rule for the residence state (the state where the holder of the financial instrument is resident, or, where applicable, the state where the recipient of the relevant income has a permanent establishment to which the income is attributable).

Notes

[41] 2014 OECD Consultation on Recommendations for Domestic Laws, Figure 3., at 23.

[42] *Ibid.* Figure 19., at 73.

[43] *Ibid.* Figure 20., at 74.

The primary linking rule, to be introduced by the source state, should provide that such jurisdiction would not allow a deduction for any payment made under a hybrid financial instrument that results in a hybrid mismatch to the extent that it gives rise to a D/NI income.[44]

The secondary, defensive rule, to be introduced by the residence state of the payee of the income (or the state where the payee has a PE to which the income is attributable), provides that such jurisdiction should require a payee to include any payment made under a hybrid financial instrument as ordinary income to the extent that the payer's jurisdiction does not neutralize the mismatch.

The primary linking rule would imply, in the basic hybrid loan case illustrated in Figure 1., that Country B. should deny B Co a deduction of interest payments to the extent that Country A would (still) allow a dividend exemption to A Co and to the extent that the payments would not be treated as ordinary (taxable) income of A Co. In the example of Figure 2. – the basic hybrid financial instrument structure using a deferred purchase price – the mismatch does not pertain to dividend payments and a general exception to the dividend exemption for deductible payments, if implemented, would therefore not neutralize the mismatch. Resorting to the primary linking rule, the mismatch would in this example be neutralized by Country B denying deduction to B Co for the relevant part of the deferred purchase price. The secondary, defensive linking rule, would for the example in Figure 1. – the basic hybrid loan – imply that Country A would have A Co include the deductible dividend payment as ordinary income in its tax base. On the same token, in the example of Figure 2., the defensive rule implemented by Country A implies inclusion as ordinary income in the tax base of A Co of the part of the deferred purchase price that is deductible in Country B.

The specific linking rules should in principle only regard situations where the mismatch is not caused by a dividend exemption (assuming residence countries would apply the above exception to such exemption where a mismatch would occur). In devising the specific linking rules and in defining the scope thereof, the 2014 OECD Consultation on Recommendations for Domestic laws started off with the following framework:[45]

– The rule should define the term *financial instruments.* These instruments should in any case include debt and equity instruments and equivalents.

– The rule should identify those payments under the instrument that give rise to a mismatch (i.e. deductible in one jurisdiction without inclusion as ordinary income in any (other) jurisdiction).

– The rule should establish whether the mismatch is *attributable to a hybrid element*. This means that the mismatch (D/NI) should be the result of a differing tax characterization or treatment of the payment rather than a result of a particular feature of the taxpayer. This implies that the primary linking rule (no deduction in the source state) may apply with respect to a payment made to an exempt corporate taxpayer in another jurisdiction, if such payment would have been exempt if the recipient were an ordinary taxpayer. Conversely, there would be no mismatch for purposes of the linking rule if the non-inclusion is the result of the taxpayer's exempt status (e.g., a charity), rather than an objective exemption with respect to the payment.[46]

– The linking rule should neutralize the effect of the hybrid financial instrument by aligning tax treatment of the payments made under it. This implies that the financial instrument itself would not – for other (tax) purposes – be re-characterized (this may for instance be relevant for thin cap rules), but that only the tax treatment of the payment there under is at issue. Secondly, this approach implies that the tax treatment is only adjusted with respect to the portion of the payment for which there is a mismatch.

This approach from the 2014 OECD Consultation on Recommendations for Domestic laws is also reflected in Recommendation 1. of the Report. In addition, the Report includes an exception to the scope of the primary linking rule in the source state for payments made to qualifying investment vehicle (located in Country A in the example), to the extent that the participants in such vehicle are taxed on a current basis for investment income earned by (and through) the vehicle.[47]

3.1.2 *Disregarded Payments Made by a Hybrid Entity to a Related Party*

In this D/NI scenario, A Co lends funds to a wholly owned subsidiary, B Co. B Co is a transparent entity for tax purposes from Country A's perspective, but is an opaque entity under Country B's tax law. Through tax consolidation of B Co and B Sub 1 in Country B, the interest on the loan from A Co to B Co is deductible against the operating income of B Sub 1. Country A

Notes

[44] A payment gives rise to a D/NI outcome 'to the extent the payment is deductible under the laws of the payer jurisdiction but is not included in the ordinary income by any person in the payee jurisdiction or by any related investor in the payee.' – Report, Recommendation 12., 'Other Definitions', at 71.

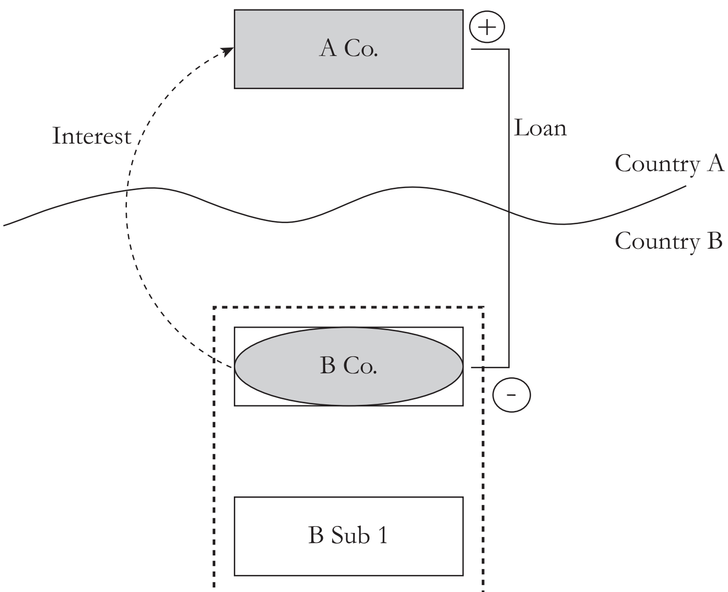
[45] 2014 OECD Consultation on Recommendations for Domestic Laws, Figure 3., at 28–29.

[46] *Ibid.*, Figure 4., at 29.

[47] Report, Recommendation 1, item 5, 'Exceptions to the Rule', at 38–39.

recognizes B Sub 1 as an opaque corporate body and the operating income of B Sub 1 is thus out of scope of Country A's taxation (i.e. no dual income inclusion). The Report characterizes B Co as a 'hybrid payer'. Because of the fact that B Co is ignored for Country A's tax purposes, the loan from A Co to B Co and interest payments on this loan are also not recognized in Country A (amounting to non-inclusion; the interest payment is a 'disregarded payment' in Country A). In this example, a hybrid entity is used (B Co), but a very similar D/NI effect may be achieved by replacing B Co, in the above scenario, with a permanent establishment of A Co in Country and by having this PE enter into a tax group with B Sub 1 in Country B.[49] The rule recommended in the Report to solve the D/NI resulting from this hybrid mismatch is the introduction of a linking rule (Recommendation 3. – disregarded hybrid payments rule).[50] The *primary* response should be for the payer jurisdiction (Country B in the example) to disallow the interest deduction. This primary corresponds to the first-bite-at-the-apple principle giving the source state the privilege to – if desired – solve the mismatch that is perceived to erode its taxable base. The *defensive* response would be for the payee jurisdiction (Country A) to include the interest payment in the ordinary income of A Co, to the extent that the interest payment (still) results in a D/NI. The Report specifies that no mismatch occurs – and no anti-hybrid measures would need applied – to the extent that the deduction in the payer jurisdiction is balanced against dual inclusion income, i.e. income that is included in ordinary income under the laws of both the payer and payee jurisdiction. The Report allows for timing differences between deduction of disregarded payments and dual inclusion income, by permitting that 'excess deductions' (i.e. deductions exceeding dual inclusion income in a certain tax reporting period) are available for set off against dual inclusion arising in another period through a carry-forward or carry-back mechanism.

Figure 3 Disregarded Payments Made by a Hybrid Entity to a Related Party[48]



The Report limits the material scope of the linking rule to *disregarded payments* made by a *hybrid payer* (as these terms are applied in the above example).[51] As to the personal scope of the anti-hybrid measure, the Report recommends that the rule should only apply if the parties to the mismatch are in the same 'control group'[52] or where the payment is made under a *structured arrangement* to which the taxpayer covered by the rule is party. In defining disregarded payments, the Report does not refer to any specific type of payment, e.g., interest payments. Thus, the example in Figure 3. would in principle also be relevant for income and assets other than interest and loans

Notes

48 Report, Figure 2.3, at 42.

49 2014 OECD Consultation on Recommendations for Domestic Laws, Figure 10., at 49.

50 Report, at 43–45.

51 Report, Recommendation 3., at 44, defines these terms as follows: '(a) A *disregarded payment* [Italics added] is a payment that is deductible under the laws of the payer jurisdiction and is not recognized under the laws of the payee jurisdiction. (b) A person will be a *hybrid payer* [Italics added] where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be disregarded payment.'

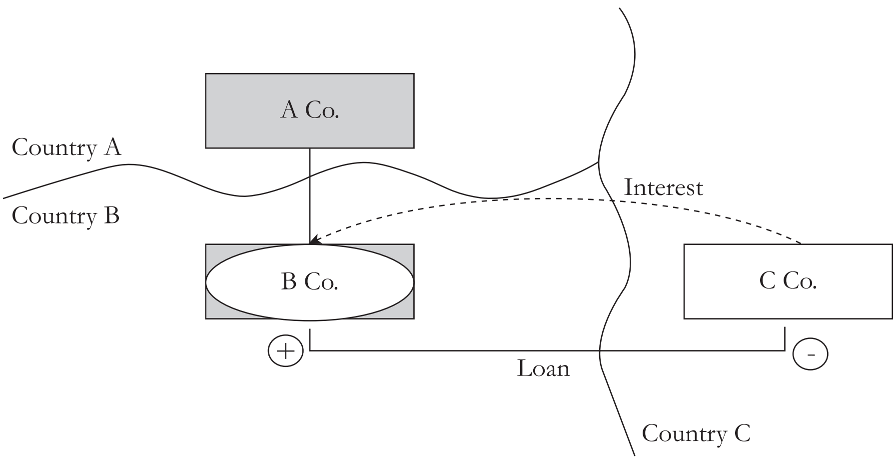
52 See *supra*, footnote #26 for definition.

respectively, for instance lease payments in relation to movable property or royalty payments in connection with licenses. Consider, for instance, a lease payment for the lease of a movable asset used in the business of B Co or B Sub 1, payable by B Co to A Co in the above example. The taxable income from the use of such asset in the tax consolidated group of B Co and B Sub 1 consists of the positive spread between the income attributable to the use of the asset (e.g., lease payments from a sub-lease to a third party) and the deductible lease payment payable to A Co. The lease payment from B Co to A Co is not included in the taxable income of A Co (in either Country A or Country B). This amounts to a D/NI outcome.[53] This scenario would in any case likely not work with lease payments on real estate rented by B Co from A Co, as such real estate (assuming it is located in country B) would arguably lead to a taxable presence of A Co in Country B with inclusion of the lease payments in A Co's tax base in Country B.

3.1.3 *Reverse Hybrids*

The Report describes mismatches through *reverse hybrids* as a mismatch in tax outcomes arising out of payments made *to* a hybrid entity, whereby the hybrid entity is treated as opaque in the jurisdiction of its foreign owner and transparent in the jurisdiction where it is established.[54] This mismatch arrangement is effectively a reversal of the mismatches through what the 2014 OECD Consultation on Recommendations for Domestic Laws called *hybrid entity payments* (the latter referring to D/NI or DD outcomes from payments made *by* a hybrid entity – see above paragraph 2.2.1. and below paragraph 2.3.1. respectively).

Figure 4 Payment to a Foreign Reverse Hybrid[55]



In the above example given in the Report, A Co wholly owns B Co, an entity characterized as opaque under Country A tax law and as tax transparent in Country B. B Co extends a loan to C Co, resident in Country C. Interest paid on the loan is ignored by Country B, given B Co's tax transparency and absent any tax nexus to Country B. The interest payment is also not recognized as ordinary income of A Co by Country A, as it sees B Co as a separate entity that not have tax nexus to Country A. Thus, this arrangement may give rise to a D/NI outcome – deduction of interest in Country C without inclusion in either Country B or Country A. This scenario should also work with other types of payments than interest, to the extent that B Co's activities do not amount to a permanent establishment or some other form of taxable presence in Country B. – Thus, this scenario would generally only lead to a D/NI outcome where there is no or very low substance in Country B.

The solution to counter mismatches from reverse hybrids recommended in the Report is twofold: firstly, the introduction of a specific reverse hybrid rule[56] and, secondly, general recommendations for domestic tax law regarding the application of CFC or other offshore

Notes

[53] To the extent that A Co, in this example of a movable property lease, also deducts certain costs related to the asset in question, e.g., maintenance costs or depreciations, one might say that this scenario also leads to an effective DD outcome.

[54] Report, at 45.

[55] Report, Figure 2.4, at 45.

[56] Report, Recommendation 4., 'Reverse hybrid rule', at 47.

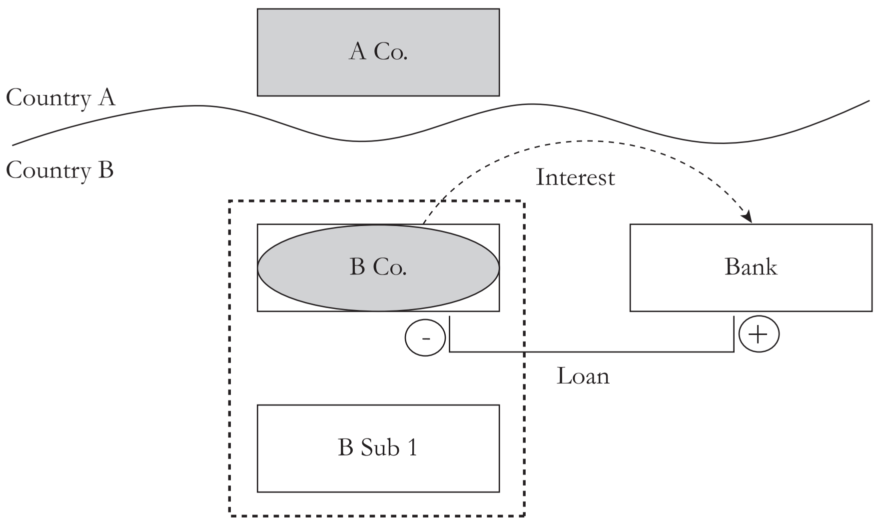
investment regimes.[57] As with the recommendations with respect to hybrid financial instruments and hybrid transfers, conceptually the general domestic tax law recommendations come first, as compliance with these recommendations may – at least to a certain extent – obviate the need for specific anti-hybrid rules.

The main general domestic tax law recommendation submitted by the OECD in Recommendation 5. of the Report is the improvement in the residence state of the investor – Country A in the above example – of CFC or other offshore investment regimes with a view to deny the D/NI outcome resulting from the reverse hybrid. The OECD suggests that such measures may form part of the deliverable of Action 3 with respect to CFC rules.[58] The Report recognizes the need to calibrate such measures with the specific anti-hybrid measures recommended in the Report – e.g., to avoid or at least mitigate double taxation resulting from the parallel application of (enhanced) CFC measures and specific anti-hybrid rules. In this respect, an item explicitly left outstanding in the Report is whether or not the application of CFC type rules with respect to certain income implies that such income is deemed to have been included in the investor's ordinary income for purposes of specific anti-hybrid rules in the source state (in which case such linking rule should not be applicable).[59] The specific reverse hybrid rule recommended in the report is for the payer jurisdiction – Country C in the above example – to deny the deduction.[60] The Report concludes that there is no need for a defensive rule, given the recommendation to introduce or enhance CFC legislation in the residence state of the investor – Country A, in the above example.[61]

3.2 *Arrangements that Produce DD Outcomes*

Two base cases are dealt with in the Report: deductible payments by a hybrid payer and dual consolidated companies. The 2014 OECD Consultation on Recommendations for Domestic Law contain variations on these basic scenarios, for which the same recommendations should apply.

Figure 5 Basic Double Deduction Structure Using Hybrid Entity[62]



3.2.1 *Deductible Payments Made by a Hybrid Payer*

The above Figure, taken from the Report, represents a basic double deduction structure using a hybrid entity. A variation with the same result is the following: basic double deduction structure using a permanent establishment (mentioned but not further elaborated in the Report; included as Figure 7. in the 2014 OECD Consultation on Recommendations for Domestic Laws). In this example, A Co wholly owns B Co. B Co is considered tax transparent by County A and is an opaque entity under

Notes

57 Report, Recommendation 5., at 49.

58 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Action 3 – Strengthen CFC rules, at 16–17.

59 Report, at 12.

60 Report, Recommendation 4., at 47.

61 Report, at 47.

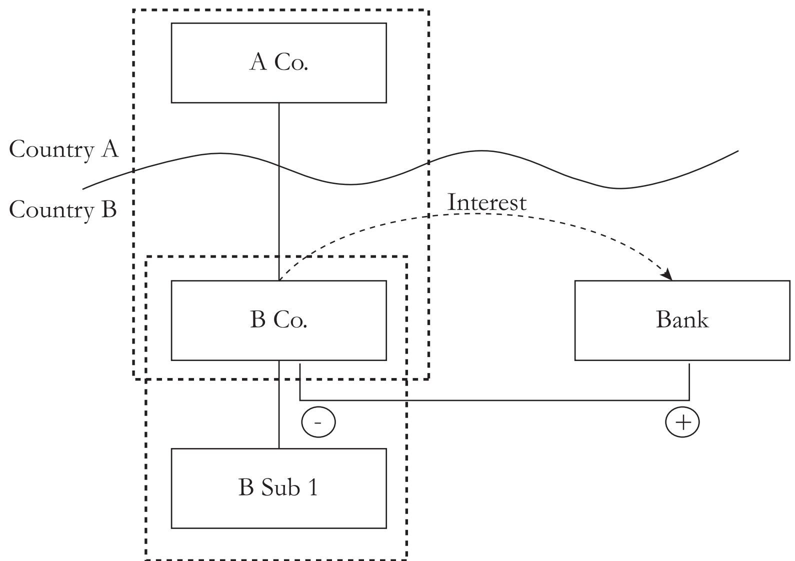
62 Report, Figure 3.1, at 51.

Country B's tax law. B Co heads a Country B tax group with its wholly owned subsidiary, B Sub 1. B Co attracts a bank loan. Interest on this bank loan is deducted in Country B against operating income of B Sub 1 (absent taxable income of B Co in Country B) and also in Country A against operating income of A Co (separate, non-dual inclusion income). In principle works for any type of income, but expectedly predominantly for interest payments, as other types of deductible payments (royalty, lease, etc.) would likely be offset by corresponding taxable income at B Co level.

The recommended hybrid mismatch rules in the Report (Recommendation 6., Deductible hybrid payments rule) are as follows. The recommended primary response is to deny the deduction in Country A (the parent jurisdiction) at A Co level to the extent there is a DD outcome. The defensive rule would be to deny deduction in Country B (the payer jurisdiction). The explanation for the choice for the location of the primary rule could be that the bank loan – in the example – will likely be used to finance B Sub 1's operating activities. It makes sense to allow deduction for such third party financing of operating activities in the source state (Country B) and to deny the (duplicate) deduction in the residence state (Country A, in the example). The hybrid mismatch rules only apply to a hybrid payer (B Co in the above example).[63]

There is no limitation in personal scope for the primary rule – as mentioned above, a viable explanation for this is that the deduction does not necessarily pertain to related party income. An exception applies for the defensive rule (denial of deduction in the payer jurisdiction), which is limited to controlled groups and structured arrangements – this limitation makes sense, because outside a controlled group it would be more difficult to assume that B Co, in the above example, would possess the relevant information regarding the duplicate deduction at A Co level. There is an exception to the hybrid mismatch rules to the extent of set-off of the relevant expenses against dual inclusion income; a carry-over rule applies as well.

Figure 6 Dual Consolidated Companies[64]



3.2.2 *Dual Consolidated Companies*

The above example works similar to Figure 5. The hybrid element here is the duplicate deduction by a dual resident entity. The primary rule recommended by the Report is for *both* resident states to deny the deduction to the extent that the relevant payment gives rise to a double deduction.[65] Also here an exception to the hybrid mismatch rule applies for deductions against dual inclusion income. Allowance is made with respect to excess deductions (denied in a given tax period), which can be carry-over to another period. 'Stranded losses' – a duplicate denial of deduction – would have to be avoided by allowing the taxpayer to give counter evidence. The application of the primary rule to both resident states

Notes

63 Report, Recommendation 6., 'Deductible hybrid payments rule', item 2, at 53–54: 'A person will be treated as a hybrid payer in respect of a payment that is deductible under the laws of the payer jurisdiction where: (a) the payer is not a resident of the payer jurisdiction and the payment triggers a duplicate deduction for that payer (or a related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction) [e.g. where the payer has a PE in the payer jurisdiction, cf. Figure 7. in the 2014 OECD Consultation on Recommendations for Domestic Laws]; or (b) the payer is resident in the payer jurisdiction and the payment triggers a duplicate deduction for an investor in that payer (or a related person) under the laws of the other jurisdiction (the payer jurisdiction) [cf. the example of Figure 5. above].'

64 Report, Figure 3.2, at 55.

65 Report, Recommendation 7., 'Dual resident payer rule' at 56–57.

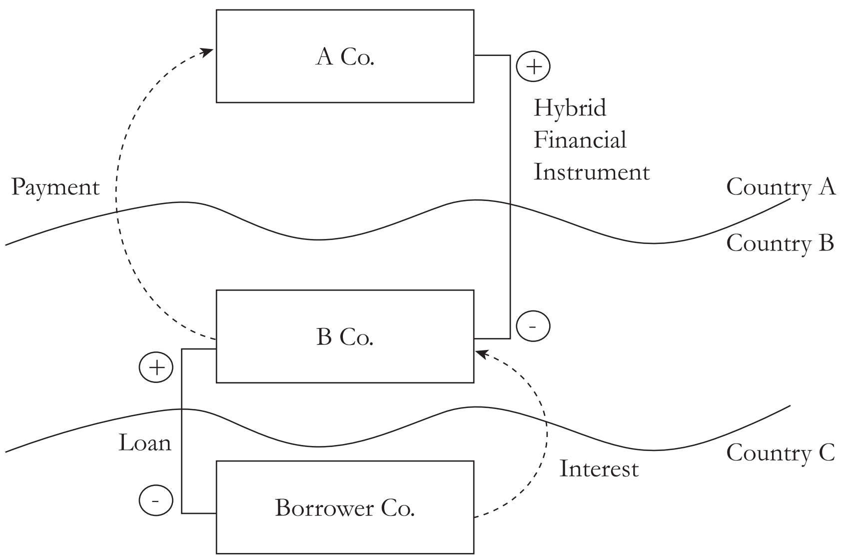
makes sense in the absence of a tie breaker to settle the dual residence.

The examples in Figure 5 and Figure 6 only lead to DD outcomes to the extent there is non-dual inclusion income, that is to say that on a stand-alone basis B Co has negative income that can be offset against taxable income of another taxpayer (B Sub 1 in the examples) Hence, these examples would likely only work with interest payments, as other types of payments (for instance lease payments on movable property) would suggest the generation of corresponding – dual inclusion – operating income at B Co level.

3.3 *Arrangements that Produce Indirect D/NI Outcomes (Imported Mismatches)*

An indirect D/NI outcome is achieved when a deduction in a certain state is on balance not accompanied by an inclusion of the income in another state, through the use of a hybrid arrangement between two other states. Of course, if every state will adopt the recommended rules for the neutralization of direct mismatches, indirect mismatches will become obsolete as well, since there will be no mismatch left to import into another jurisdiction.[66] This scenario however does not seem very likely. It is therefore understandable that arrangements producing indirect D/NI outcomes are addressed in the Report as a separate category since they lead to a proliferation of mismatch arrangements. Via these arrangements, mismatches can be exploited even if there is no disparity between the domestic laws of states of residence of the ultimate investor and lender. If for example a subsidiary needs funding, and there is no disparity between the laws of the state of residence of the parent and the subsidiary which might give rise to a hybrid mismatch, a double dip or deduction without inclusion may still be achieved via these arrangements. Take for example figure 7 (of an importing mismatch from a hybrid financial instrument):

Figure 7 Importing Mismatch from Dual Consolidated Companies[67]



There may be no mismatch arrangement possible between the domestic laws of Country A and Country C. However, in this case a mismatch between the domestic laws of Country A and country B may be used, as a result of which a deduction in State C without an effective inclusion in either State A or B can still be achieved:

– A Co. is not taxed on the income from the hybrid financial instrument;
– Borrower Co can deduct interest on the loan; and
– B Co is taxed on the balance of the income received on the loan and the consideration paid on the hybrid financial instrument.

Obviously this scheme only works if Country A does not follow the recommendation to disallow the exemption for deductible payments, and Country B does not apply the hybrid mismatch rule.

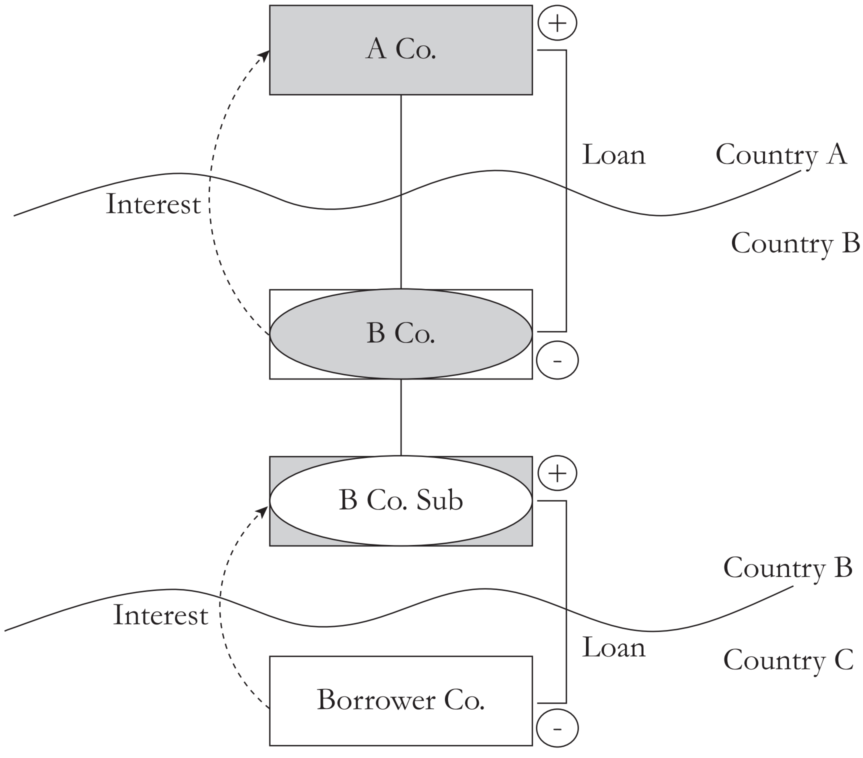
The import of a mismatch can also be achieved through a hybrid entity. See for example the Tower structure (Figure 8).

Notes

66 Report, para. 108, at 60.

67 Report, Figure 4.1, at 59.

Figure 8 Tower Structure: Exporting Mismatch from Hybrid Entities into Third Jurisdiction[68]



In this example, B Co is treated as transparent under the laws of Country A, and as a company under the laws of Country B. For B Co Sub this is the other way around. This leads to the following consequences:

– From the perspective of Country A, B Co is disregarded (and so is the interest paid by B Co. to A Co.). The interest paid by Borrower Co. to B Co Sub is not taxed in Country A, since B Co Sub is not a resident of Country A.

– From the perspective of Country B, B Co receives interest from Borrower Co., and pays interest to A Co. As a result, only an interest spread is taxed on balance.

– The interest paid by Borrower Co. is deductible in Country C.

The loan between B Co Sub and Borrower Co. stand alone does not give rise to a D/NI outcome since the income is included in the tax base of Country B (i.e. in the hands of B Co).[69] However, the mismatch caused by the disregarded payment (on the loan between A Co. and B Co) is imported to Country C through the loan between B Co Sub and Borrower Co.

The recommended response in the Report is to deny deduction in the payer jurisdiction. The rule applies if all parties to the mismatch are in the same control group or if the taxpayer is party to a structured arrangement. There is no recommendation for a defensive rule, presumably because a defensive rule would overlap with responses to direct mismatch arrangements.

Rules targeting at indirect mismatches may be in particularly burdensome, since the application of these rules do not only demand the assessment of the tax treatment of the income in the hands of the recipient, but also (i) the identification of other transactions within the same set of transactions and (ii) the identification of possible mismatches in tax treatment in two jurisdictions. Of course, the administrative burden is mitigated by the limit in scope of these rules. Still, also in the Report it is acknowledged that there may be situations where it would be disproportionate and unduly burdensome to require the taxpayer to apply the rule in non-structured arrangements[70] (which could only be the case for taxpayers which are in the same control group as the parties to the imported mismatch arrangement, in view of the envisaged scope of the mismatch rule). In our view, in order to leave

Notes

68 2014 OECD Consultation on Recommendations for Domestic Laws, Figure 13., at 59.

69 See Report, para. 82, at 46.

70 Report, para. 111, at 60.

the rules practical and foreseeable, it is essential that it is clearly determined how to identify a link between the payment made by a taxpayer one the one hand and a mismatch arrangement entered into by the recipient of the payment on the other hand.

4 Treaty issues

4.1 *General*

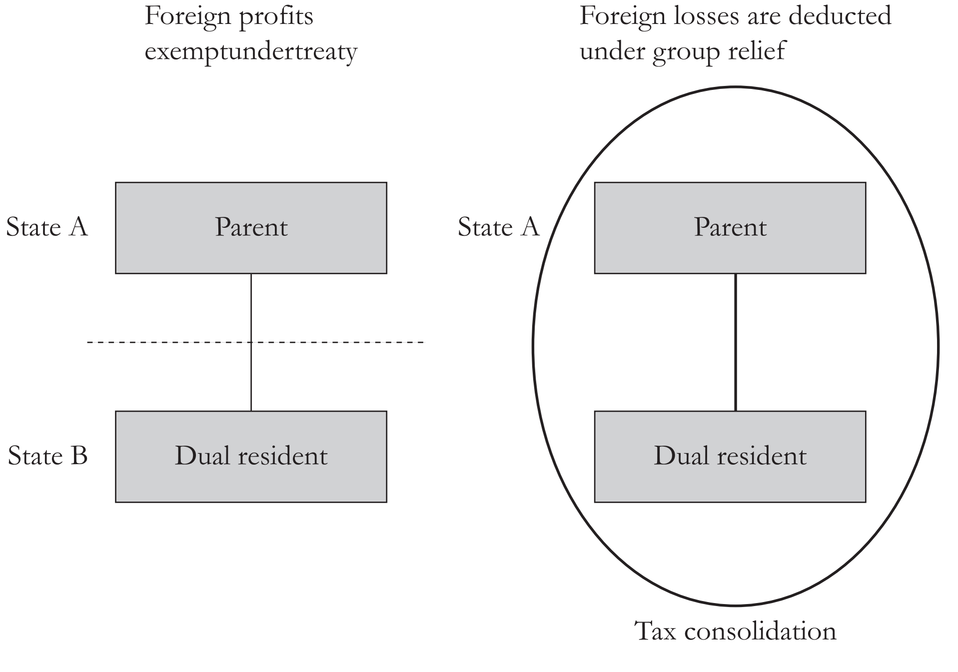
The main outcomes of the work on Action 2 are expected to result from mismatches in domestic laws.[71] This makes sense since the mismatches are mainly derived from disparities between domestic tax laws. Nevertheless changes to the OECD MC seem necessary. Action 2 of the BEPS Action Plan called not only for the design of domestic rules, but also for the development of model treaty provisions, more in particular the development of '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'. The issues which are dealt with fall within the scope of two themes: issues with dual-resident entities (see section 4.2), and issues with transparent entities (see section 4.3).

It is submitted that the objective (ensuring that hybrid instruments and entities and dual resident entities are not used to obtain the benefits of treaties unduly) can also be achieved, to a certain extent, by the results of the work on Action 6 (Preventing Treaty Abuse), e.g., by LOB rules, main purpose tests, etc.[72] These fall outside the scope of this contribution.

4.2 *Dual Resident Entities*

The work on Action 6 has resulted in a recommendation to revise Article 4(3) OECD MC so as to implement a MAP instead of following the current rule based on effective management. This revision will solve the majority of double residency for treaty purposes, but there would be remaining concerns related to dual-resident entities, in particular avoidance strategies resulting from an entity being a resident of State A under State A's domestic law whilst, at the same time, being a resident of State B under a tax treaty concluded by State A. The concerns are that such entity would be able to benefit from the advantages applicable to residents under domestic law of State A without being subject to reciprocal obligations (due to the application of the tax treaty). An example could be the following situation (see figure 9).

Figure 9 Dual Resident Mismatch



71 2014 OECD Consultation on Recommendations on Treaty Issues, at 4.

72 Report, para. 125, at 79.

The report mentions the situation where the entity (in above example: Parent) would be able in case of losses of the dual resident: to shift these losses under a domestic law group relief system, and in case of profits of the dual resident: to claim treaty protection against taxation of its foreign profits.

The core issue is that the tie-breaker rule in principle only has consequences for the application of the treaty (and perhaps for the application of other treaties, see Paragraph 8.2 of the Commentary to Article 4(1) OECD MC), and not (necessarily) for residency under domestic law. Mismatches between the treaty and domestic law concepts of residence would therefore not be solved. This mismatch must be solved under domestic law. The Report suggests two possible solutions: to tackle this arrangement through domestic general anti-abuse rules, or to insert a rule according to which the loser state adopts the tie-breaker result under tax treaties for the application of its domestic law.[73] We have a preference for the second solution, for the following reasons. First, this will align domestic law treatment and treaty application. Second, this solution avoids the introduction of yet another criterion: instead, the criterion applied in the tiebreaker rule in the respective treaties could serve a double purpose. Third, the application of a GAAR will inevitably lead to legal uncertainty. We submit that another solution is also conceivable. Instead of solving the mismatch, states may insert rules in their domestic law which deny cross-border loss compensation (e.g., the disallowance of group relief in relation to companies which are resident of another state under a treaty,[74] or the introduction of a full exemption for foreign profits and losses[75]). In that case, mismatches would be avoided without any need to resolve double residency.

Other concerns raised in the report arise from dual-residency where no treaty is involved.[76] These issues are out of scope of this contribution.

4.3 *Transparent Entities*

It is not the first time for the OECD to deal with hybrid entities issues. Hybrid partnerships have given rise to concerns for quite some time, since they may lead to both double taxation and double non-taxation. In 1999 the OECD issued its report 'The Application of the OECD Model Tax Convention to Partnerships' (hereinafter: the Partnership Report). The main conclusions of the Partnership Report have been included in the Commentary of the OECD Model Tax Convention (see paragraphs 2 through 6.7 of the Commentary to Article 1 OECD MC). In this report, the OECD recommended to treat income of transparent entities as income of a resident, for the application of the OECD MC, if either of the Contracting State treats the income as the income of one of its residents under its domestic law. This rule serves two purposes: it ensures that the benefits of tax treaties are granted in appropriate cases (i.e. avoiding double taxation) and it avoids that these benefits are granted where neither Contracting State treats the income of an entity as the income of one of its residents.

The Report proposes to address the issue of hybrid entities in accordance with the principles of the Partnership Report. It proposes to include a paragraph 1(2) in the OECD MC in order to solve mismatches for all hybrid entities, not just partnerships, thereby also solving the issue that some countries have found it difficult to apply the conclusions of the Partnership Report. The proposal seeks to ensure that income derived by or through hybrid entities is considered to be income of a resident of a Contracting State to the extent that the income is taxed in the hands of a resident of that State. The recommended paragraph reads as follows:

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.]

As illustration for the above rule, the following case is described in the draft Commentary to this provision (see paragraph 26.7).

The entity established in State B is a company (and therefore subject to tax) under State A law, but tax transparent under the domestic law of State B. Both members are taxed on half of the income of the entity. State A and State B have concluded a tax treaty in conformity to the OECD MC. Article 1(2) of the treaty provides that in such case, the interest paid by a debtor of State A to the entity shall be considered to be income of a resident of a State B to the extent that the member resident in State B is taxed on the interest (in this case half of the interest).

Notes

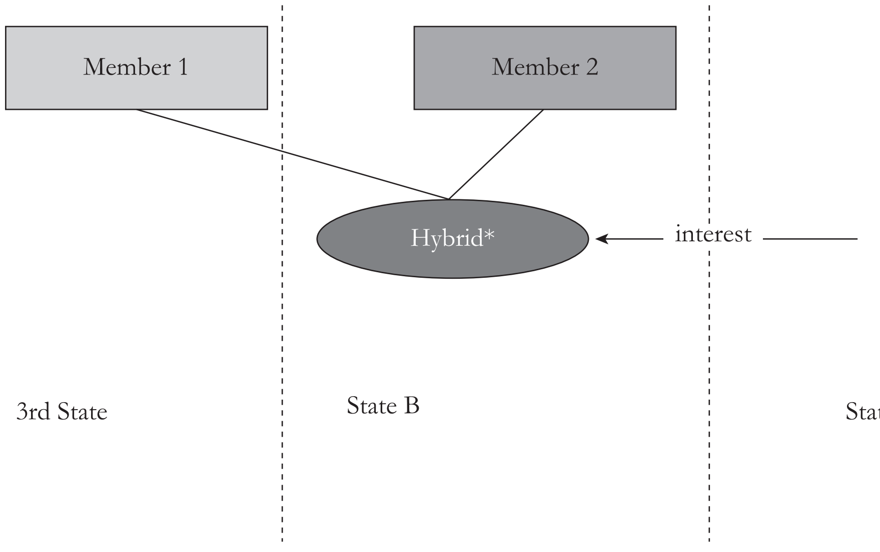
73 Report, para. 128, at 81–82.

74 Which would in our view be compatible with EU law; see Case C-337/08, X Holding [2010] ECR I-01215.

75 Which would in our view also be compatible with EU law; see Case C-414/06, Lidl Belgium [2008] ECR I-03601.

76 Report, para. 129, at 82.

Figure 10 Pro Rata Treaty Entitlement



*Transparent under domestic law State B

If, in the above example, the entity were taxed over its profits in State B, all of the interest is considered to be income of a resident of State B. It is also possible that the entity is taxed on part of the income (e.g., the general partner's share of the income of an LP, or the undistributed part of the income of a trust[77]), and that the other part is taxed in the hands of participants (e.g., the limited partners) or beneficiaries. In that case it must be established for both parts of the income separately whether they are taxed in the hands of a resident of a contracting state (see paragraph 26.11 of the proposed Commentary).

5 EU Law and non-discrimination in double tax treaties

5.1 *General*

The Report does not address EU law issues, which is remarkable since a considerable part of the countries involved are EU Member States. Below we will briefly discuss some issues concerning the conformity of the recommendations in the Report with EU law, more in particular the fundamental freedoms, the EU Parent Subsidiary directive and the State aid provisions (paragraphs 5.2–5.4).[78] We will also briefly discuss compliance with the non-discrimination in the OECD MC (paragraph 5.5).

5.2 *Fundamental Freedoms*

Since in particular cross-border payments are targeted by the recommended rules, a question is whether those rules would violate the fundamental freedoms embodied in the Treaty on the Functioning of the European Union ('TFEU'), more in particular the freedom of establishment (Article TFEU) and the free movement of capital (Article 63 TFEU). There are arguments for the position that these recommended rule would restrict these fundamental freedoms. It is settled case-law that any advantage resulting from low taxation in one Member State cannot by itself authorize another Member State to offset that advantage by less favourable tax treatment in that state. For instance, in case C-294/97 (Eurowings),[79] the CJ EU held that less favourable treatment given to recipients of services on the basis of a tax advantage resulting for providers of these services from the low taxation to which they are subject in the Member State in which they are established, is not permitted, and that such compensatory tax arrangements would prejudice the very foundations of the single market. One could also refer to the Cadbury-Schweppes case,[80] where the CJ EU held that any

Notes

[77] The term 'entity or arrangement' is supposed to have a broad meaning and to cover trusts also [see 26.8].

[78] We will not discuss the Interest & Royalty directive since it only affects the taxation of the income in the source state, and does not limit the taxing rights of other jurisdictions nor the application of deduction limitation rules in the source state (see also Case C-379/09, *Scheuten Solar Technology* [2011] ECR I-06455).

[79] Case C-294/97, *Eurowings* [1999] ECR I-07447, points 44–45.

[80] Case 196/04, Cadbury-Schweppes, point 49 (with reference to other case-law).

advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorize that Member State to offset that advantage by less favourable tax treatment of the parent company. In our view, however, a distinction should be made between compensatory taxation in order to offset favourable tax treatment on the one hand, and the neutralization of hybrid mismatches on the other hand. As the CJ EU held in the Schempp case,[81] Germany was allowed to render the deductibility of maintenance payments by a taxpayer resident in that Member State to a recipient resident in another Member State conditional on their being taxed in that other Member State. The disadvantage resulting from the payments not being subject to tax is considered a disparity, and not a discrimination, so long as the domestic rules affect all persons subject to them in accordance with objective criteria.[82] The Schempp case was ruled on the basis of Article 12 EC (now 18 TFEU). In our view, there is no reason why a different conclusion should be reached if other treaty freedoms apply. It appears that according to the CJ EU, the condition for deductibility of payments of the payments being subject to tax in the hands of the recipient, is not considered to be discriminatory. A situation where these payments are not subject to tax is not considered comparable to a situation where these payments are taxed,[83] and consequently, there is no discrimination.[84] In our view, the same should be true for an exemption which is made subject to the condition of the absence of a deduction by the payer. The argument seems even stronger where the rationale of the exemption is the objective to avoid juridical or economic double taxation. We conclude that general coordination rules in principle do not violate the EU fundamental freedoms. A question might be whether this is different where a less favourable tax position is not an accidental result of the domestic measure but where the domestic measure, as is the case for the recommended hybrid mismatch rule, specifically targets hybrid mismatch arrangements which can only arise in cross-border situations. We expect that the CJ EU will reach the same conclusion as in the Schempp case, and accept that a hybrid mismatch arrangement is not comparable to a domestic situation.[85] The reasoning would be the same: payments which are subject to tax are not objectively comparable to payments which are not. If this were not true, and the measure would be considered discriminatory, the next question would be whether there is an overriding reason in the public interest capable of justifying it. Although the currently accepted reasons do not seem to be available for the justification of the recommended hybrid mismatch rules,[86] ensuring single tax might be accepted by the CJ EU as an overriding reason.[87] In any event (and on another note), one might question whether the CJ EU will be immune for international consensus which may be reached as a result of the public debate on tax arbitrage, and would be willing to rule that domestic measures in conformity with OECD recommended and G20 endorsed hybrid mismatch rules are unjustified discriminatory measures.

5.3 *EU Parent Subsidiary Directive*

The recommendation regarding the adjustment of dividend exemption systems (i.e. the limitation of scope to non-deductible payments) seems to be in conformity with the amended Article 4(1)(a) of the EU Parent Subsidiary Directive. Member States applying the exemption system (instead of a credit system) method should 'refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary'. If EU Member States were to implement the recommendation to deny dividend exemption for deductible payments, they should – in cases falling within the scope of the Parent Subsidiary Directive – interpret the condition of non-deductibility in conformity with Article 4(1)(a) of the EU Parent Subsidiary Directive.[88] This would mean, in our view, that the parent State should refrain from taxation to the extent that the payments, although characterized as interest payments, are not deductible (e.g., on the basis of an earnings stripping, thin capitalization or other anti-base erosion provision).

5.4 *State Aid*

Article 107(1) TFEU provides that any aid granted by an EU Member State or through state resources, which distorts or threatens to distort competition by favouring

Notes

81 Case C-403/03, *Schempp* [2005] ECR I-6421.

82 Schempp, points 32–36.

83 Schempp, point 35.

84 Schempp, point 36.

85 Cf. Jakob Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1, ET 2013 (Vol. 53), No. 11, at 5.4.3.

86 See also Jakob Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 2, ET 2013 (Vol. 53), No. 12.

87 *Ibid*. at 6.1.

88 See e.g., joined Cases C-397/01 to C-403/01, *Pfeiffer* [2004] ECR I-8835, points 114-118. See also B.J.M. Terra and P.J. Wattel, European Tax Law, 2nd ed., Kluwer Deventer 2012, at 118–120.

certain undertakings or the production of certain goods are incompatible, insofar as it affects trade between Member States. Measures in a tax code may generally constitute state aid if they make an exception to the 'normal' system of taxation, unless that exception has been notified to the European Commission and the Commission has approved it.[89] State aid is in principle a one-state issue: it is a matter of one state granting a selective advantage from its resources to certain undertakings. Double non-taxation resulting from hybrid mismatch arrangements involves two (or more) jurisdictions, with each jurisdiction applying the rules from its normal system of taxation. Hybrid mismatches result from disparities between two (or more) jurisdictions and thus pose a *two-state* issue, without either state handing over a selective advantage.[90] One might ask whether domestic rules that solicit the use of (hybrid) mismatches may constitute State aid.[91] With respect to a proposed Dutch group interest regime (never enacted) that taxed intra-group interest at an effective rate of 5% (substantially lower than the general statutory rate, currently at 25%), arguably facilitating arbitration between deduction of interest in the source state against a relatively high rate and taxation in the Netherlands at the low 5% rate, the European Commission eventually held that this regime did not constitute prohibited State aid. The Commission decision explicitly confirmed that benefits for multinational enterprise that follow from disparities in a cross-border situation – such as resulting from the group interest regime – fall outside the scope of State aid, as such disparities are not attributable to either of the states involved.[92]

The rules creating or allowing the hybrid mismatch arrangements are thus very unlikely to constitute prohibited State aid. However, a (selective) carve-out from the hybrid mismatch rules for certain taxpayers may not be permissible from a State aid perspective. Given that the exceptions to the hybrid mismatch rules as summarized in the Report[93] are still in a conceptual phase,[94] it would seem premature at this stage to submit these exceptions to a State aid analysis – nonetheless the proposed exception for investment vehicles from the primary rule in Recommendation 1 on hybrid financial instruments and hybrid transfers would warrant further scrutiny.

5.5 *OECD MC*

The primary response under the recommended hybrid mismatch rule in part I of the Report is typically the denial of a deduction for payments. The OECD MC only deals with the allocation of taxing rights, and – in principle – not with the deduction of costs. In the Commentary it is acknowledged that Articles 6–22 of the Model Convention do not interfere with the computation of the tax base.[95] As the Report rightly states,[96] the provisions of tax treaties do not govern whether payments are deductible or not, apart from the rules of Articles 7 and 24. We would add: and Article 9, which may be relevant for the application of thin capitalization rules,[97] but this Article does not seem to apply to the hybrid mismatch rules (even though the scope of hybrid mismatch rules is typically limited to associated parties), since these rules are not targeted at non arm's length situations in particular. The question is whether the primary responses are in compliance with Article 24(4) OECD MC. Article 24(4) OECD MC provides that, except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12,

Notes

89 The European State aid rules as laid down in Art. 107 of the Treaty on the Functioning of the European Union ('TFEU') prohibit granting: (i) an advantage, (ii) to an undertaking, (iii) through state resources, (iv) which is selective, and (v) which threatens to distort competition on the common market and may affect trade between Member States. These conditions are cumulative. The term 'advantage' is not limited to (direct) subsidies granted by government bodies but also includes advantages granted by public authorities which, in various forms, mitigate the charges which are normally included in the budget of an undertaking. In essence, it must be determined whether the beneficiary is receiving an economic advantage which it would not have obtained under normal market conditions. Advantages below the so-called de minimis threshold (EUR 200,000) are exempted from the prohibition. The term 'an undertaking' includes any entity involved in an economic activity regardless of its legal form, activities or objectives. As regards 'state resources': there is no necessity to draw any distinction according to whether the advantage is granted directly by the State or by public or private bodies established or appointed by it. However, actions by public undertakings need to be 'imputable' to the State. 'Selectivity': for public support to be considered State aid, the aid needs to favour *certain* undertakings or the production of certain goods, as opposed to *general* measures. 'Distortion of competition' and 'effect on inter-state trade': for the purposes of these notions, it is necessary, not to establish that the aid has a *real* effect on trade between Member States and that competition is *actually* being distorted, but only to examine whether that aid *is liable* to affect such trade and distort competition. Article 108(3) TFEU provides that Member States may not implement new State aid measures before they have been approved by the Commission ('standstill obligation'). This provision has direct effect in Member States' judicial systems.

90 That is not to say that a general system that – a prima vista – does not award selective advantages, may not be deemed to be State aid, to the extent that such system – through clever regulatory techniques – disguises that in fact it does grant selective benefits – see for instance joined Cases C-106/09 P and C-107/09 P, *Commission v. Government of Gibraltar*.

91 See for instance P.J. Wattel, 'Forum: Interaction of State aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters', 5 World Tax J. 5 (2013), section 4.: 'If a Member State refrains from curbing, or even solicits, (ab)use of disparities between national legislations, resulting in double non-taxation, does that constitute State aid or harmful tax competition?'.

92 Commission decision of 08.07.2009, C(209)4511 final, para. 125, at 23.

93 Report, at 38–39.

94 See for instance Report, para. 111, at 60, where exceptions to the imported mismatch rule on non-structured arrangements are hinted at.

95 See para. 38 of the Commentary to Art. 23A OECD MC.

96 Report, point 134.

97 See para. 3 of the Commentary to Art. 9 OECD MC.

apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. According to the Report the recommendations 'do not appear to ... provide different rules for the deduction of payments made to residents and non-residents'.[98] And: 'The fact that a mismatch in the tax treatment of an entity or payment is less likely in a purely domestic context ... cannot be interpreted as meaning that rules that are strictly based on the existence of such mismatch are treating payments to non-residents, or to non-residents owned enterprises, differently from the way payments to residents, or resident-owned enterprises are treated under domestic laws.'[99] It is true that the recommended primary response rules do not – at least not formally – differentiate between payments to residents and non-residents. They do appear, however, to discriminate de facto. The scope of the hybrid mismatch rule is limited to mismatches that rely on a hybrid element.[100] It is therefore not merely a coincidence that the hybrid mismatch rule is 'less likely' to apply in domestic situations. On the contrary, the rule will only in exceptional cases – if at all – apply in domestic situations,[101] although we stress that the rule may very well apply to cross-border payments to a resident payee.[102] In any event, the recommended rules can only be said to be in conflict with Article 24(4) OECD MC if the recommendations provide different rules for the deduction of payments made to residents and non-residents. In order for that conclusion to be reached, it should first be determined whether domestic situations and hybrid mismatch arrangement are – in the context of anti-mismatch rules – comparable, and second, whether deduction is not possible under 'the same conditions' as required in Article 24(4) OECD MC. Although in Article 24(4) OECD MC there is no reference to the same circumstances of the comparator, we concord with Van Raad that this is inherent in the concept of non-discrimination.[103] The question is whether hybrid mismatch arrangements should be considered a 'circumstance'. Should the conclusion be that the absence of a hybrid mismatch is a relevant circumstance in order to arrive at comparability, or should a hybrid mismatch be considered a characteristic inextricably linked with residence, as a result of which it should be disregarded in the comparison?[104] In our view the question boils down to the question whether the absence of a hybrid mismatch is a relevant characteristic for the deductibility of the payment, in other words whether it is a legitimate distinction.[105] We submit that this is indeed so: neutralizing hybrid mismatches is a legitimate policy objective and the rules for the neutralization of these mismatches apply only in cross-border situations because of the nature of these mismatches, not due to the objective to treat domestic payments more favourable. This would in our view be different in cases where the domestic rule would effectively result in the denial of the deduction of payments in cross-border situations, without targeting comparable domestic situations (e.g., if payments to domestic exempt entities were deductible, whereas payments to foreign exempt entities were not).

6 Evaluation

6.1 *Introduction*

The OECD's strategy is an effort to try and devise pragmatic rules. The Report includes careful advance rebuttals of expected criticism: yes, the rules may be technically challenging and may in some instances amount to overkill, but if they are effective in deterring taxpayers from setting up hybrid mismatch arrangement, then these drawbacks are substantially mitigated if not theoretical. And yes, the 'beef' is in the execution and implementation – how to achieve widespread adoption and implementation of measures and how to secure consistency in timing and content of measures? – but the Commentary and other guidance to be issued later on will try and clarify these matters. In this respect, the Report is still very much in progress. Nonetheless, in our below evaluation we will try and briefly address the following three items:

– What is the policy rationale behind the fight against mismatches?

– May the recommended hybrid mismatch rules work? What are the (practical) drawbacks?

Notes

98 Report, para. 143, at 97.

99 Report, para. 144, at 97.

100 See e.g., Report, paragraphs 41ff, and in particular 46, at 29–30.

101 As is stated in the Report (para. 144), 'one would expect a country to be consistent in the way it characterises domestic payments and entities'.

102 For example, where the payment is attributed to a foreign permanent establishment.

103 K. van Raad, *Nondiscrimination in International Tax Law* 176 (Kluwer, Deventer, 1986). A different position is taken by N. Bammens, The Principle of Non-Discrimination in International and European Tax Law, IBFD, Amsterdam, 2012, p. 338–344.

104 Cf. Van Raad, *ibid.* p. 176.

105 Cf. para. 1 of the Commentary to Art. 24 OECD MC.

– Are there viable alternatives to the recommended hybrid mismatch rules, that may (partly) achieve the intended result at less cost to taxpayers and administrations?

6.2 *Why Tackle Mismatches?*[106]

In its 2012 Hybrids Report, the OECD identifies five policy issues with regard to hybrid mismatch arrangements:

– *Loss of tax revenue.* According to the OECD, international hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by all parties involved, both through the operation of the arrangement itself and through deduction of advisory costs in the implementation thereof.

– *Distortion of competition.* The OECD notes that multinational enterprises with access to sophisticated tax expertise may profit from hybrid mismatch opportunities, whereas other businesses, such as small and medium-sized enterprises, would not have (easy) access to such opportunities. This would create unintended competitive advantages.

– *Negative impact on economic efficiency.* The OECD has considered that the use of a hybrid mismatch arrangement may negatively affect both capital export neutrality (CEN) and capital import neutrality (CIN), in that it renders a cross-border investment more attractive than an equivalent domestic investment in the investor's country (CEN) as well as more attractive than a competing local investor's investment in the target country (CIN). Furthermore, the OECD notes that hybrid mismatch arrangements may potentially contribute to financial instability through increases in leverage from tax-favoured borrowing, through increases in risk-taking (as investments which are uneconomic before tax become marginally viable after tax) and through a relative lack of transparency caused by the adoption of tax-driven structures.

– *A lack of public transparency.* The OECD assumes that the public will be generally unaware that taxpayers that can profit from mismatch opportunities have a lower effective tax rate than might expected based on statutory rates, and that even where there is awareness regarding effective tax rates, it may be unclear to the public how such rates come about.

– *Fairness.* In the view of the OECD, 'fairness relates to the fact that mismatch opportunities are more readily available for taxpayers with income from capital, rather than labour. The ability of a select group of taxpayers to reduce their taxes could be perceived as unfair, thus affecting public confidence in the fairness of the tax system. This is to some extent linked with the competitive advantages hybrid mismatch opportunities may give to some businesses but not to all'.[107]

It is possible to question the overall validity of these policy considerations and to try to determine whether the considerations of the OECD should be decisive, or whether other factors should also be properly weighed. No effort will be made here to decide this argument, but some nuanced observations will be offered below.

As a starting observation, it appears that the OECD primarily frames the use of (hybrid) mismatches as a problem of taxpayer behaviour and as an issue of inter-taxpayer equity (not merely among taxpayers within one jurisdiction, but also from a more global perspective, comparing large multinational corporations with smaller domestic enterprises). In this view, hybrid mismatches amount to aggressive tax avoidance, in which a taxpayer complies with the letter of the law, but does not have any regard for its spirit and purpose. Taxpayers availing themselves of such arrangements do not pay their fair share in comparison with other taxpayers. This is clearly a different angle than that taken in the discussion on harmful tax competition in the late 1990s, in which arguably inter-nation equity, or the attribution of a 'fair share' of gains and losses among states, was primarily at stake. One could argue that a primary focus on inter-taxpayer equity is one-sided and that hybrid mismatch arrangements and the measures aiming to counter such arrangements should in equal part be analysed from an inter-nation equity perspective. Some might then argue that inter-nation equity is also threatened by mismatches (referring for instance to specific features in tax regimes introduced specifically to create mismatches). Others might claim that mismatches are an inevitable consequence of the sovereign exercise of taxing power of a state and that they do not affect inter-nation equity, other than any other benefit provided by such state.

Notes

[106] This paragraph substantially derives from Ch. 3, 'Preliminary Observations on the European Commission's Strategy for Tackling Hybrid Mismatch Arrangements' (by Reinout de Boer), para. 3.2, in *The European Union's Struggle with Mismatches and Aggressive Tax Planning*, Report of the Amsterdam Centre for Tax Law (ACTL) Conference held in Amsterdam on 5 Apr. 2013 (Reinout de Boer and Martijn Nouwen (ed.)), Eleven International Publishing 2013, at 50–57.

[107] In much the same vein, in the Commission Recommendation of 6 Dec. 2012 on aggressive tax planning, the European Commission identifies the following downsides of hybrid mismatch arrangements: mismatch arrangements may contravene the intent of domestic tax law; may lead to unintended tax base erosion; may stimulate artificial capital flows and movements of taxpayers; and may generally be harmful to the functioning of the internal market. As regards the element of fairness, the Commission makes it clear that aggressive tax planning, including through the use of hybrid mismatch arrangements, is to be considered contrary to the principles of 'corporate social responsibility'. Multinational enterprises should pay their 'fair share' of tax.

The argument that the use of mismatches between national tax systems may lead to overall *loss of tax revenue* would seem hard to refute, when comparing a situation in which there is a mismatch with a situation in which no such mismatch would occur.[108] However, in and of itself, loss of tax revenue is not a decisive reason to tackle specific mismatch arrangements or, for that reason, any type of lawful behaviour by taxpayers. First, the term 'loss' implies an *a priori* entitlement to the revenue in question. In the case of mismatches, such entitlement seems debatable from the perspective of each individual state concerned, assuming that the mismatch arrangement abides by the law – and even if there is an *a priori* entitlement, it would seem hard to find a compelling factor in deciding how such entitlement is to be allocated to the states concerned.[109] Second, in the case of mismatches, perceived loss of tax revenue is an effect of the differences between tax systems, which differences continue to exist due to lack of coordination between states. There are alternative solutions to recapture the ensuing perceived revenue loss. First, states could attempt to align their tax systems – admittedly, this may, for the moment, be a utopian illusion.[110] A second solution could be to raise general tax rates – in the current economic climate, further increase of tax rates, which would likely hit immobile factors such as labour and local consumption, may be hard to swallow for the general public and their political representatives, and understandably so. We will not venture into the realm of political taboo by suggesting that a third solution to dealing with revenue loss from mismatches would be to reduce public spending.

As regards the argument that mismatches distort competition between large multinational corporations on the one side and small and medium-sized enterprises on the other, the starting point would be to look at the effective corporate income tax that is paid by the relevant taxpayers. Certain individual cases may suggest a widespread pattern of effective rates approaching zero,[111] but many other multinational corporations may have effective tax rates that are similar to smaller enterprises that they compete with on domestic markets.[112] Domestic business may even benefit from substantially lower rates than their multinational counterparts, for instance as a result of progressive tax rates or beneficial tax regimes targeted at small and medium-sized enterprises. Assuming that empirical data on effective tax rates would indeed suggest a substantially lower effective tax rate for large multinational corporations, one could ask whether this is in fact a problem from a tax policy perspective. Some might say that having a digressive tax rate is perfectly justifiable (if perhaps not politically acceptable).

In his 1998 Tillinghast Lecture, professor David Rosenbloom puts the validity – or at the very least, the internal consistency – of the argument that mismatches distort competition and should therefore be neutralized into serious question.[113] For instance, how are hybrid mismatches different from other techniques for taking advantage of differing tax rules in different countries? Where to draw the line? Which tax benefits are relevant and which are not? It is easy to think of the use of regimes that would create a potential dual benefit (if not strictly speaking a 'hybrid mismatch') in cross-border situations – for instance by shifting economic activities to low taxing jurisdictions. Which tax policy justifies the elimination of otherwise available tax benefits for the sole reason that the person enjoying such benefits also enjoys benefits (tax or otherwise) in another country? And a more fundamental issue: why would state *A* care about the level of tax in state *B*, if state *A* receives the revenue that it believes it is due based on its domestic law? The latter question implies that at least inter-nation equity – or the division of a *fair share* of gains and losses among nations – may not necessarily be jeopardized by (hybrid) mismatches.

Some comments on the 'fair share' approach and corporate social responsibility are in line here.

First, there are as yet no clear criteria, either qualitative or quantitative, for establishing what would constitute a fair share of taxation for any given multinational corporation, and how such fair share should then be attributed to jurisdictions in which it operates. Establishing such criteria on the basis of ethical principles would seem to be near impossible, given that it is difficult to see how an ethical principle – formulated outside the framework of tax law formulated in the usual sources of tax law, such as laws, regulations and case law – would lead to a quantifiable tax assessment, abstaining even from the lack of consensus on such principle. If morality should play a role, the authors would tend to agree with those who say that tax law and tax compliance should be

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108 The OECD is assuming a loss of tax revenue based on inductive reasoning, looking at individual cases. No data seem to be available that demonstrate the overall loss of revenue. 'Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues' (OECD, 2012).

109 A straightforward approach might be simply to split the relevant tax base between the two states concerned on a 50–50 basis.

110 Again, the lukewarm response in EU Member States to the Commission's CCCTB proposal speaks volumes.

111 See e.g., 'Across U.S. Companies, Tax Rates Vary Greatly', *The New York Times*, (25 May 2013) (reporting an effective tax rate for Amazon in the period 2007–2012 of 6%).

112 See *ibid.* (reporting a combined effective tax rate for S&P 500 companies of 29.1%).

113 H.D. Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the 'International Tax System'*, 53 Tax L. Rev. 137 (2000).

inspired by a moral of duty (to pay what is legally due, *intra legem* yet not *in fraudem legem*), rather than by a moral of aspiration (which, taken to its extreme, would lead to the tendering of voluntary payments).

That does not mean, of course, that corporate social responsibility is irrelevant for tax and that tax is a mere line item in a company's profit and loss account. The concept of corporate social responsibility may certainly be useful for corporations as a way to interact with their various stakeholders and their expectations, and to thus optimize the balance between the overall tax cost and adverse external consequences of unadulterated tax engineering. Multinational corporations are trying to get their bearings in this area and some have already integrated tax as part of their policies on corporate social responsibility.[114] The focus in such initiatives seems to be on transparency and compliance with the law[115] – transparency being necessary to engage in any kind of meaningful interaction with stakeholders to gauge mutual expectations, and compliance with the law being an evident fundamental principle, even if it may not always be unequivocally clear what the law is.

The need for clarity in the law brings to mind another dimension of the fair-share approach, and that is that tax legislators have a responsibility to draft clear and robust legislation that is not overly vulnerable to unintended tax planning. This is true for national legislation, but also applies to the international tax arena. Where states are unable or unwilling to coordinate their tax systems, it is difficult to understand why taxpayers should, based on a fair share concept, refrain from benefiting from or even actively using existing mismatches.

Without deciding the policy argument for or against specific hybrid mismatch rules – which should ultimately be decided through the widespread adoption thereof taking into account due democratic legislative process – the principled discussion on the need to tackle mismatches would in our view at the very least serve to underpin the strategy of the OECD in the Report to first try and repair basic flaws in domestic law that are conducive to mismatches, to make sensible limitations in material and personal scope of the recommended hybrid mismatch rules and to provide (extensive) guidance on implementation and coordination of the measures.

6.3 *Do the Recommended Hybrid Mismatch Rules Work? What Are Potential Drawbacks?*

Assuming the widespread adoption of the recommended hybrid mismatch rules and taking into account the implementation and coordination challenges the Report itself has already identified, we could certainly see how the recommended measures may go a long way in eradicating double non-taxation resulting from hybrid mismatch arrangements. However, abstaining from the more political question whether states have the will and the stamina to jointly introduce relatively workable and reasonably effective anti-hybrid measures, principal questions on the merits of linking rules remain.

A first question might be why only hybrid mismatches arrangements resulting in double non-taxation are dealt with, and double taxation is disregarded.[116] In our view it is not imperative that double non-taxation be targeted together with double taxation, although this would be sympathetic. The issue is that double non-taxation, unlike double taxation, is intended in many occasions. It is precisely this type of double non-taxation which the recommended rules are targeted at, rather than unintentional hybrid mismatches, either resulting in double taxation or double non-taxation.

Another issue is the compliance burden. Rules specifically targeting at mismatches are burdensome, since the application of these rules demand scrutiny of the tax treatment in another jurisdiction, including the cause of the tax treatment (e.g., personal exemption versus hybrid mismatches).[117] The definition of a hybrid mismatch may be challenging, e.g., the distinction between a timing mismatch and a hybrid mismatch resulting in a genuine D/NI (irrespective of whether this is defined as a permanent mismatch or long-term deferral) or DD result (irrespective of whether this is defined as a permanent double dip or long-term double dip).[118]

Furthermore, rules may need to be adjusted post implementation, and there may be a risk of non-coordination in that stage.[119] Additional issues arise in the context of indirect mismatches, since the application of the recommended rules targeting these arrangements do not only demand the assessment of the tax treatment of

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114 *See* e.g., A. van Eijsden, *The Relationship between Corporate Responsibility and Tax: Unknown and Unloved*, EC Tax Review, 2012–1.

115 *Ibid.*

116 Cf. Hans van den Hurk, Proposed Amended Parent-Subsidiary Directive Reveals the European Commission's Lack of Vision, BIT 2014 (Vol. 68), No. 9, at 2.2.3, who argues that the Amendment of the Parent-Subsidiary Directive is unsatisfactory because it solves only one side of the problem.

117 See Oana Popa, *Hybrid Entity Payments – Extinct Species after the BEPS Action Plan?* ET 2014 (Vol. 54), No. 9, at 5.2.

118 See Jürgen Lüdicke, *Tax Arbitrage' with Hybrid Entities: Challenges and Responses* BIT, 2014 (Vol. 68), No. 6/7.

119 See Oana Popa, *Hybrid Entity Payments – Extinct Species after the BEPS Action Plan?* ET 2014 (Vol. 54), No. 9, at 5.3.

the income in the hands of the recipient, but also (i) the identification of other transactions within the same set of transactions and (ii) the identification of possible mismatches in tax treatment in two jurisdictions. This results in a high level of complexity. This complexity may be mitigated by the limitation in scope, but complexity is not avoided, not in the least because the scope is extended to structured arrangements, which is a rather vague concept.

Linking rules create new issues, which may in turn be potentially harmful cross-border investment. Consider three of these draw backs.[120] Linking rules may well create overkill and may thus negatively affect cross-border transactions and investment. Suppose that residence states of the recipient of a dividend are obliged to no longer exempt intragroup dividends if such dividends are deductible from the tax base in the hands of the company paying the dividend (e.g., pursuant to the – mandatory – denial of such exemption under the amended EU Parent-Subsidiary Directive). In purely domestic situations, such measure would not be applicable and therefore would have a neutral effect (no deduction at source, exemption upon receipt). In cross-border situations, however, such measure may well lead to overkill or 'underkill'. Overkill would for instance occur if there were a deduction at source at an effective rate of 15%, while there is taxation upon receipt at a rate of 25%. Underkill – in that there would still be a mismatch in tax rates, which mismatch could be substantial – would occur if the tax rates in the previous example were exchanged. The overkill is arguably the result of an insoluble disparity.

It is further submitted in literature that entities and people realizing the same economic profit should face the same tax bill in a certain jurisdiction, and that coordination rules resulting in the disallowance of expenses creates an uneven playing field.[121]

6.4 *Alternatives*

As follows from the above, the use of specific hybrid mismatch rules has quite some drawbacks. It seems worthwhile considering – as the BEPS project progresses – whether there are alternatives that may be more feasible. Chances are that these will create more overkill as the recommended rules are very specifically targeted at hybrid mismatches. On the other hand, alternatives may be easier to administer. Below we will focus primarily on alternatives for the hybrid mismatch rules (rather than the specific recommendations on improvements to domestic law).

As mentioned above, the problem of the hybrid mismatch arrangements in many occasions seems to be confined to interest deduction: all or almost all examples in the discussion draft and the Report have deductible interest as common element. DD outcomes seem difficult to achieve without the element of deductible interest. (For example, in cases of deductible wages, rentals, royalties, etc. it seems hard to avoid positive double inclusion income.) Also D/NI elements may be achieved more easily through interest payments as compared with other types of payments. An exception applies to reverse hybrids,[122] which generally also allows for a D/NI outcome through other types of payments than interest. However, the latter category of arrangements is primarily tackled via CFC rules or equivalent rules rather than the application of the hybrid mismatch rule.[123] This raises the following question: should the problem not be solved by interest deduction limitations? Of course it must be admitted that in the majority of cases the recommended primary response is already the denial of a deduction. Should hybrid mismatch arrangements be tackled via interest deduction limitations, this would mean that presumably the scope of the rules will on the one hand be more limited (only interest expenses) and on the other hand more extensive (not only hybrid mismatches, but also – e.g., – payments to low tax jurisdictions). For example, an approach which may be effective, and less complex, may be the introduction of a simplified mismatch rule,limiting the deductibility of related party interest to interest which is included in the tax base of the recipient (and if not, irrespective of the reason why it would not be included in the tax base[124]). Another complementary measure could be the introduction of a more generic interest deduction limitation, such as the limitation of excessive interest deduction through thin cap or earnings stripping rules, or via global allocation of interest expenses by formulary

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[120] See also Ch. 3, 'Preliminary Observations on the European Commission's Strategy for Tackling Hybrid Mismatch Arrangements' (by Reinout de Boer), para. 3.5.1., in *The European Union's Struggle with Mismatches and Aggressive Tax Planning*, Report of the Amsterdam Centre for Tax Law (ACTL) Conference held in Amsterdam on 5 Apr. 2013 (Reinout de Boer and Martijn Nouwen (ed.)), Eleven International Publishing 2013, at 67–68.

[121] Stephen Edge, Base Erosion & Profit Shifting: A Roadmap for Reform – Tax Arbitrage with Hybird Instruments, BIT 2014 (Vol. 68), No. 6/7, at 7.

[122] And to a lesser extent, disregarded payments made by a hybrid entity to a related party.

[123] For disregarded payments made by a hybrid entity to a related party, an equivalent may be to limit the exemption available in the residence state with respect to the hybrid entity.

[124] So even in the absence of a different characterization of the income, e.g., no exceptions for payments to exempt entities (an exception that *is* made for the hybrid mismatch rules in the Report).

apportionment.[125] Such generic interest deduction limitations would mitigate the double non-taxation resulting from hybrid mismatches and may dissuade taxpayers from entering into such arrangements.

In this respect we note that it is difficult to assess the merits of the recommendations of Action 2 without the possibility to take the recommendations in the context of Action 4 (base erosion) into account. Since it is unknown which types of hybrid mismatch arrangements will already be deterred by the proposed recommendations on Action 2, it is hard to determine whether the pros of the recommended hybrid mismatch rule outweighs its cons (e.g., legal uncertainty and the compliance burden).

7 Conclusions and recommendations

- The Report (including the published work leading up to the Report) represents a daring effort in the identification, dissection and reduction to their essential elements of complex hybrid mismatch arrangements.
- The recommendations for specific anti-hybrid measures appear to have – at least conceptually – the potential to counter double non-taxation. The OECD has evidently tried to devise measures that are pragmatic as well as effective.
- The OECD has made sensible choices with respect to:
  - scope (related parties, control group, structured arrangements); and
  - the jurisdiction to which primary and secondary linking rules apply, in each case allocating the primary to the jurisdiction that should be allowed the first bite at the apple under widely accepted principles of international tax (even if one does not accept the premise that such principle is a matter of (customary) international (tax) law.).
- A critical factor for successful implementation is widespread adoption. There may be less political will to actually pull through than would seem apparent from the G20's endorsement of the Report – individual states stand to lose both revenue and inbound investment if effective tax rates increase through successful implementation of anti-hybrid rules.
- The Report still leaves open a number of issues of both a principal and a practical nature. Some of these issues will be addressed by the OECD later, in a Commentary that is to be published ultimately in September 2015, at the time the deliverables on Action 3 (CFC) and 4 (interest deduction) are planned to be announced.
- Even if one accepts the premise of the OECD strategy underlying the Report – namely that they should primarily act as a deterrent for entering into hybrid mismatch arrangements – one cannot deny that the recommendations will lead to burdensome administration and legal uncertainty.
- Given the draw backs of specific anti-hybrid rules as to practical and political feasibility, a further review of alternatives is warranted, particularly with respect to CFC and interest deduction limitations. A more simplified mismatch rule applicable to interest seems particularly worthy of further investigation, given that hybrid mismatch arrangements almost always evolve around interest deduction (a notable exception applies with respect to payments to reverse hybrids; however, effective CFC rules may be effective in countering this particular brand of mismatches). In addition, more generic interest deduction limitations (as opposed to specific hybrid mismatch rules) may be a viable, complementary way to mitigate double non-taxation resulting from hybrid mismatches and thus act as sufficient discouragement for entering into such arrangements.

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[125] See for example the plan proposed by the Obama administration – *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, Department of the Treasury, March 2014. See also Chloe Burnett, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach', World Tax J. 6 2014, at 40–76.