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Neutralizing Effects of Hybrid Mismatch Arrangements

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

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

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

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

1 See Boidman & Kandev (2014) p. 1233.

2 OECD (2014) para. 17 defines a 'hybrid mismatch arrangement' as 'a profit shifting arrangement that utilises a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement.' This definition appears unduly restricted to 'profit shifting', 'entities', 'instruments' and 'payments'.

administrations, especially those of developing countries, can or will effectively interpret the tax laws of other countries.

Mismatches arising in the context of a hybrid arrangement may be one of two basic types. A mismatch may be harmful to the tax outcome of the taxpayer (when compared to a consistent treatment by both countries) or it may be beneficial to the taxpayer. Historically, tax treaties have, in a number of ways, dealt with styles of mismatch that are harmful to taxpayers. These include the reconciliation of residence of the taxpayer, often the source of income and transfer pricing adjustments (through corresponding adjustments) and even the provision of foreign tax relief (where otherwise both source and residence countries would exercise full taxing rights). The primary purpose of tax treaties has been to relieve international double taxation in order to facilitate cross-border investment.[3] In the face of globalisation, countries are more clearly than ever in a market place for attracting investment, a market place that demands relief from double taxation, which is reflected in the proliferation of unilateral measures for the relief of double taxation.[4] In this way, globalisation fundamentally challenges the necessity of tax treaties.

Current concerns with hybrid mismatch arrangements are with arrangements that are beneficial to taxpayers. While mismatches might also be harmful to taxpayers, it is likely that a well advised taxpayer will plan to avoid such mismatches. As Action Plan 2 of the OECD Base Erosion and Profit Shifting Project highlights ('Action 2'),[5] the focus of current concerns (and this paper) is on multinationals intentionally planning for hybrid mismatch arrangements to reduce their overall tax payable. Action 2 essentially focuses on double non-taxation of income and claiming deductions simultaneously in more than one country against different items of income, i.e. the OECD sees hybrid mismatch arrangements as essentially involving tax base issues.[6]

The tax results from use of hybrid mismatch arrangements are often comparable to those involving the use of tax havens and so there is a clear synergy with the OECD's harmful tax competition project. The difficulty with hybrid mismatch arrangements is that they can and most commonly do involve countries that are not classically tax havens. Indeed, they commonly involve countries that are parties to a tax treaty, reinforcing that the fundamental purpose of tax treaties has historically been to relieve international double taxation and not prevent international double non-taxation. Hybrid mismatch arrangements that are beneficial for taxpayers seek to simultaneously erode both taxation in the source state and taxation in the residence state. Accordingly, this paper is closely related to other papers in this project.

This paper proceeds to discuss hybrid mismatch arrangements under four headings. The first heading seeks to scope the issue by conceptualising it. It does so by identifying income tax fundamentals and highlighting how they can give rise to mismatches across borders. Some simplified examples are used in the discussion to illustrate potential taxpayer

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3 For example, see Ault (2013) p. 1199.

4 These unilateral measures involve not only foreign tax relief as a residence state, but most importantly for present purposes the reduction of source state taxation to realistic levels, e.g. with respect to outbound withholding taxes. Many developing countries now have outbound domestic withholding taxes that are near to those that traditionally would only have been agreed under a tax treaty.

5 Action Plan 2 calls for the development of 'model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities.' OECD (2013) p. 15. The OECD Committee of Fiscal Affairs set up Working Party No. 11 to facilitate this development.

6 See OECD (2014) para. 17 and particularly the references to 'profit shifting' and 'payments'.

benefits from hybrid mismatch arrangements. In this way, this paper seeks to explain as simply as possible why mismatches arise and the range of mismatches that are possible.

The second and third headings look more particularly at how the OECD proposes to deal with such arrangements under the Action 2. The second heading identifies which types of mismatches identified under the first heading are the subject of Action 2 and which are not. The third heading considers how the OECD Draft proposes to deal with the targeted mismatches. In particular, the third heading assesses the practicality of implementing the OECD proposals, especially from the perspective of a developing country.[7]

The fourth heading returns to the basics discussed under the first heading and considers whether there are simpler steps that countries, especially developing countries, may take to alleviate the problems caused by hybrid mismatch arrangements. In particular, the OECD proposals require an unprecedented level of integration between countries' tax systems and laws. Discussion under the fourth heading considers whether the problem of hybrid mismatch arrangements can be dealt with in ways that require lower levels of integration. The focus here is on two anti-base erosion measures that a source state can take, but also considers measures that may be taken by a residence state. Inevitably, there is no 'one size fits all' solution to the problems of hybrid mismatch arrangements and countries must make their own decisions based on their own capacity and economic needs.

1.1 Scoping the problem

1.1.1 Income tax fundamentals

There are three essentials that all income tax laws incorporate and each of these three essentials (persons, earning activities and income) demonstrates a number of fundamental features that income tax laws must detail. Income tax laws are personal taxes and so must identify the 'persons' to whom they apply. Persons are taxed with respect their 'income'. However, not all amounts that 'come in' or which may be allocated to a person fall within the ambit of a typical income tax. Inevitably (and through differing legislative mechanisms) only income that can be related to an 'earning activity' (an activity that is not private) falls within the scope of an income tax. Within the scope of an earning activity certain amounts positively enter into the calculation of income and some amounts are entered negatively, i.e. for most countries income is a net concept (although there are exceptions, e.g. sometimes for employment income).

All income tax laws must identify what constitutes a person (a tax subject or at least things that can be attributed earning activities and income). As with many other areas, here an income tax law is faced with two choices, it can either follow general legal classification (e.g. individuals and corporations as legal persons) or it can adopt a disjointed approach. Under the disjointed approach (which most countries follow), a 'person' for income tax purposes might include some entities that are not persons for general law purposes or exclude as a tax person some entities that are persons for general law purposes. It is also possible for one person to be given two capacities for tax purposes, in which case the one

7 Public comments with respect to OECD (2014) are available at <http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.htm>.

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

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

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

As for the activities through which income is earned, these are generally of three types - employment, investment and business, reflecting resources available for earning income. Income may be earned through the exclusive provision of labour - most employment falls into this category. Income may be earned through the exclusive provision or use of assets - often called 'investment'. Income may also be earned, in a myriad of combinations, through the use of labour and assets - most commonly referred to as 'business'. Just as it is possible that different countries classify 'persons' differently, it is common for countries to classify earning activities differently. Further, earning activities also demonstrate some fundamental features. Earning activities must be allocated as being conducted by particular persons. These activities may be allocated a particular situs (often related to the location of the individual activities making up the earning activity). It may also be necessary to determine when an earning activity commences and when it ends.

Each earning activity constitutes the aggregate of the provision of resources on isolated occasions (transactions) within the scope of that activity. So, in the context of an employment, these are the occasions on which the individual renders services as an employee. In the context of an investment, it is the provision (transfer or use) of the investment assets. In the context of a business it is either or a combination of both.

Each isolated provision of resources (labour and assets) must be classified for income tax purposes and will demonstrate certain fundamental features. For example, in the context of the rendering of services, it will be necessary to identify the time when the services are rendered (usually during the period when the physical labour is performed) and where the services are rendered (usually where the individual is who is physically performing the labour or where the services are used or consumed).

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

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

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

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

[8] Contrast OECD (2014) para. 21, which only provides examples of payments (an 'includes' definition) and specifically excludes 'payments that are only deemed to have made for tax purposes and that do not involve the creation of economic rights between the parties'.

1.1.2 Mismatches as to payments and the fundamental features of payments

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

The reasons why countries disagree as to the fundamentals of income taxation often pertain to one country accepting legal form and another adopting some type of substance approach, including one based on financial reporting (accounting standards).[9] The difference between following legal classification and adopting a disjointed approach for identifying persons was discussed above at 6.1.1. Another common example involves disagreement as to whether a transaction transfers the ownership of an asset or not. At one extreme, a finance lease does not transfer legal ownership but might be considered in substance to do so. At another extreme, a sale and repurchase agreement does transfer legal ownership but might be considered in substance to not do so. In the middle there can be legal mortgages (e.g. securities lending arrangements) under which the legal title to an asset is transferred as collateral for a loan.

Most commonly (although not always) mismatches with respect to persons and earning activities (and the provision of resources) manifest themselves in mismatches as to the fundamentals of a payment.[10] Therefore, the following discussion starts by considering how, without more, disagreement between two countries as to the fundamentals of a payment may give rise to cross-border mismatch opportunities. This is done in the context of six examples. Subsequent subheadings proceed to develop other examples demonstrating how mismatches as to the fundamentals of a payment can be triggered by disagreement with respect to the identification of earning activities or of who or what is a person.

Example 1 is a simple illustration of a mismatch between two countries as to whether a payment exists for tax purposes. In this example, Country B (country of creditor) sees value passing from Y (creditor) to Z (debtor) when Y forgives part of the debt. Country B also sees this 'payment' as having a sufficient business purpose and grants a deduction for it. By contrast, Country A (country of debtor) does not recognise the payment received by Z in the form of a reduction in liability. The result is a cross-border mismatch. This example focuses on countries disagreeing as to the very nature of whether there is a bestowal of value (payment) that should be recognised for tax purposes. This case should not be confused with similar examples that focus on other income tax fundamentals, such as where both countries recognize a payment but characterise it differently, e.g. Country A characterises the forgiven debt as a payment of capital and does not tax it because Country A does not tax capital gains.

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9 For a similar observation, see Edge (2014) pp 318-19.

10 As noted above, OECD (2014) focuses on hybrid mismatch arrangements involving payments, e.g. see para. 22.

Example 1
Mismatch in Identifying Payment - Deduction but No Income

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

If the reduction in the debt is looked at in isolation, there is a mismatch that gives rise to a cross-border tax benefit (deduction in Country B) with no pick up in Country A (no income). In many cases, such a scenario is not abusive, presuming that Z has unrelieved (or cancelled) losses in Country A. However, the mismatch can result in untaxed funds if from a tax perspective Z has managed to set off all of the negative results that gave rise to the arrangement against income. This income might be in Country A or elsewhere, e.g. through carry back of losses or setting losses against income from other activities, including those of related parties.

Example 2 is a simple illustration of a mismatch between two countries that recognise a payment, but disagree as to who (which person) should be treated as receiving it. In this example, both Country A and Country B see a payment as being made by Z, but they do not agree on who receives the payment. So Country A grants a deduction for the payment but neither country taxes the receipt because neither country considers the recipient of the payment to be a resident. The example notes that this is particularly a problem when source state taxation of the payment has been eroded. The example also notes that this style of mismatch is commonly triggered in the context of hybrid entities (one country considers an artificial entity as a tax subject but another country does not), discussed below at 6.1.4.

Example 2
Mismatch in Recipient of Payment - No Income

Z, a resident of Country A, makes a payment that is deductible for Country A tax purposes. Country A considers that the payment is made to Y, a resident of Country B. Country B considers that the payment is made to X, a resident of Country A.

If the taxation of the recipient in their state of residence is looked at in isolation, there is a mismatch that gives rise to a cross-border tax benefit (deduction in Country A) with no pick up as income of the recipient in a residence state. If Country A taxes the payment substantially at source (e.g. by withholding) there may be little or no benefit. However, if that tax at source has been eroded (whether unilaterally or by tax treaty) then the cross-border benefit can be substantial. A common form of this type of mismatch is where the two countries do not agree on what constitutes a tax subject (hybrid entity). However, this style of mismatch is generic and not limited to the use of hybrid entities. For example, it can also arise where two countries disagree as to which of two related parties receives a payment.

Example 3 is a simple illustration of a mismatch between two countries that recognise a payment, but disagree as to who (which person) should be treated as making it. In this example, both Country A and Country B see a payment as being received by Y, but they do not agree on who makes the payment. The income tax fundamental in issue (allocation of payment) is the same as in Example 2, but this is a different variation involving 'double dip' deductions. So Country B includes the payment in calculating Y's income, but both Country A and Country B grant a deduction for the payment to different entities, i.e. two deductions, one income. Again, this type of mismatch is often triggered in the context of payments made by hybrid entities.

Example 3
Mismatch in Maker of Payment - Double Dip Deduction

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

Presuming that both Z and X can deduct the payment against taxable income, there is a cross-border mismatch that gives rise to two tax benefits (deduction in Country A for Z and in Country B for X) with only one pick up as income (for Y in Country B). If Country A taxes the payment substantially at source (e.g. by withholding) there may be little or no benefit. However, if that tax at source has been eroded (whether unilaterally or by tax treaty) or if Country B grants Y foreign tax relief for that taxation at source (whether unilaterally or by tax treaty) then the cross-border benefit can be substantial. A common form of this type of mismatch is where the two countries do not agree on what constitutes a tax subject (hybrid entity). However, this is a generic mismatch issue and is not limited to the use of hybrid entities. For example, it can also arise where two countries disagree as to which of two related parties makes a payment.

Example 4 is a simple illustration of a mismatch between two countries that recognise a payment, but disagree as to the quantum of the payment. In this example, there are two payments (bestowals of value); one being the transfer of the asset from Z to Y and the second being the cash payment from Y to Z. Both Country A and Country B agree as to the quantum of the first payment (the asset). However, they disagree at to the quantification of the consideration paid for the transfer (the cash payment). Country A accepts the payment at its face value and calculates Z's gain/loss from the transaction accordingly. By contrast, Country B deems Y to have paid an amount equal to the market value of the asset received. The result is that Country B grants a deduction (currently or in the future) for an amount that is more than was brought into account in Country A in calculating Z's gain or loss. Again, this case should not be confused with similar examples that focus on other income tax fundamentals but also result in a smaller amount being brought into account in one country than is deducted in another country. One such similar example is where one country considers a payment received as wholly capital in nature but the country of the payer considers it as a mixture of revenue (e.g. financing expenses) and capital.

Example 4
Mismatch in Quantifying Payment - Large Deduction but Small Income

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

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

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

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

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

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

Example 6 is a simple illustration of a mismatch between two countries that recognise a payment, but disagree as to the character of the payment for tax purposes. In this example, Country A characterises the payment as interest for tax purposes and so grants Z a deduction for it. By contrast, Country B characterises the payment as a dividend, grants indirect foreign tax relief (cross-border dividend relief) and so does not tax Y with respect to the receipt. The result is a deduction in one country with no inclusion in income in the other country. This case should not be confused with similar examples that focus on other income tax fundamentals but also result in a deduction with no inclusion in income, e.g. as in Examples 1 and 2.

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

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

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

1.1.3 Mismatches as to earning activities and the provision of resources

Disagreement between countries in identifying earning activities can also give rise to cross-border mismatches, as demonstrated in Example 7. In example 7, Country A characterises Y's activities as investment and Country B as business. This results in Country A not taxing and Country B also not taxing due to the provision of foreign tax relief. This case produces 'double non-taxation' in a similar fashion as in Example 6, but in this case Country B is providing direct foreign tax relief as opposed to indirect foreign tax relief (dividend relief). Similar examples arise where the residence state thinks that a person is engaged in an earning activity, e.g. employment, and the source state thinks there is insufficient activity to constitute an earning activity (e.g. private activity).

Example 7
Mismatch of Earning Activities - No Source State Tax but Foreign Tax Relief

Y, a resident of Country B, deals in securities in Country A. Country A does not consider that the activities of Y are sufficient to amount to conducting a business and so classifies them as an investment. As a result, Country A does not tax Y with respect to the dealings. By contrast, Country B considers that Y is conducting a business in Country A (e.g. through a permanent establishment) and so grants Y foreign tax relief in the form of an exemption.

There is a mismatch between Country A and Country B as to the type of earning activity Y is conducting (investment or business). This gives rise to a cross-border tax benefit in that neither country taxes income derived from the dealing in securities. There are many variations of this style of mismatch. Some occur even though the two countries classify the activity in the same manner, as in Example 8 below.

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

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

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

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

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

Example 9 also demonstrates that disagreement as to who is the owner of an asset can trigger mismatches as to the character of a payment, but such mismatches may also be triggered by simple disagreement as to the character of an asset. In Example 9, the mismatch in ownership causes Country A to consider the payments under the finance lease as a mixture of interest and capital (purchase price) whereas Country B considers the payments as purely rent. Such a mismatch can be caused where two countries do not agree as to the character of an asset, even if they agree as to ownership of the asset. For example, if one country (Country A) considers a particular financial instrument as debt and another (Country

B) considers it as equity, this can give rise to mismatches of the type illustrated in Example 6.[11]

Example 9
Mismatch of Who Owns Asset - Double Dip Depreciation

Y, a resident of Country B, leases by way of finance lease an asset to Z, a resident of Country A. Country A considers the substance of the lease and treats it as a sale with debt financing. Accordingly, Country A grants Z tax depreciation and a deduction for notional interest paid to Y with respect to the debt financing. Country B accepts the form of the agreement as a lease and so treats Y as the owner and grants Y tax depreciation. Country B requires Y to include the rent payments received from Z in income, but also grant foreign tax relief with respect to them. In particular, Country B considers that the rent is derived through a PE in Country A.

Conceptually, it may be argued that an accurate rate of depreciation for a leased asset is equal to rent charged for the asset less a notional interest charge. In such a case, there might be little tax advantage in an example such as this one. However, most countries grant tax depreciation at a rate in excess of economic depreciation and sometimes for more than 100 percent of the cost of an asset. In such a situation, a mismatch such as in this example that gives rise to two sets of depreciation can give rise to substantial cross-border timing advantages irrespective of whether there is also a mismatch in the tax treatment of the rent payments because the countries characterise them differently.

Example 10 illustrates that mismatches as to the character of an asset can also give rise to cross-border tax benefits where the indirect foreign tax credit method (cross-border dividend relief) is used. In this example, there are two payments; payment of interest on the profit sharing debentures held by X and payment of dividends on the shares held by Y Co in Z Co. The same corporate income tax paid by Z Co in Country A is credited to both X and Z Co and the duplication causes a mismatch benefit. For this style of mismatch to produce effective benefits, it is likely that the corporate tax rate of Y Co in Country B is comparatively high and/or Country B has a broad method of calculating the limitation on credit under its foreign tax credit system, e.g. where it calculates the limitation on credit on a worldwide basis.[12]

Example 10
Mismatch in Characterising Asset - Double Dip Dividend Relief

Y Co, a company resident in Country B, owns shares in Z Co, a company resident in Country A, such that Z Co is a subsidiary of Y Co. X, a resident of Country A, holds profit sharing debentures in Z Co. Country A treats the profits sharing debentures as shares for Country A tax purposes. As a result, Country A denies Z Co a deduction for interest paid on the profit sharing debentures, but grants X dividend relief with respect to receipt of the interest in the form of dividend tax credits. By contrast, Country B considers that Y Co is the only shareholder in Z Co and so when Y Co receives a dividend from Z Co Country B grants Y

11 For an in-depth analysis of distinguishing between debt and equity in domestic and international tax law, see Schön, Bakrozis, Becker et al. (2014).

12 As to different methods of calculating the limitation on credit, see Harris (2013b) pp. 126-41.

Co an indirect foreign tax credit for all of the Country A corporate tax paid by Z Co.

There is a mismatch between Country A and Country B as to the character of the investment (shares or debt) held by X and the return payable on it (dividends or interest). This gives rise to two tax benefits in the form of crediting the same corporate tax paid by Z Co to both X (in Country A) and Y Co (in Country B). This style of arrangement is often referred to as a 'tax credit generator'.

1.1.4 Mismatches as to persons and personal characteristics

Countries may disagree as to whether an entity constitutes a person for tax purposes (hybrid entity) and this may give rise to mismatches as to whether a payment has been made, as illustrated in Example 11. In Example 11, Country B sees Z Co as part of the entity that is Y whereas Country A considers Z Co and Y as separate tax entities. This makes Z Co a 'hybrid entity'. The interest payment by Z Co is recognised by Country A (paid between two persons), but not by Country B (paid by Y to itself). In this sense, Example 11 is similar to Example 1 and demonstrates how the classification of persons for tax purposes can impact on whether a payment is recognised. Example 11 is also similar to Example 7 in that Country A sees Y's activities as an investment (a loan), whereas Country B sees Y's activities in Country A as business activities.

Example 11
Mismatch in Identifying Person - Deduction but No Income

Y, a resident of Country B, establishes Z Co in Country A. Y loans money to Z Co and Z Co pays interest in return. Country A considers that Z Co is a taxable person and so grants a deduction for the interest paid. Country B considers Z Co as transparent (not a taxable person) and so does not recognise any loan transaction or payment of interest between Y and Z Co. Rather, Country B considers the activities of Z Co as a PE of Y in Country A and as a result grants Y foreign tax relief in the form of an exemption of Y's activities in Country A.

There is a mismatch in the treatment between Country A and Country B. The mismatch gives rise to a cross-border tax benefit (deduction in Country A) with no pick up in Country B (no income). In this sense the example is similar to Example 1. The cross-border benefit may be minimised if Country A imposes a substantial source based tax. Further, the benefit may be minimised if Country B adopts the foreign tax credit method of foreign tax relief. Tax planning of this variety presumes that the residence state (Country B) calculates the exemption for the Country A PE without a deduction for the interest. As such, the exemption will be larger than what Country A taxes to Z Co. A foreign tax credit would credit to Y only tax actually paid in Country A (although mismatches in calculating the Country A income can cause difficulties in calculating the limitation on credit).

Mismatches of the type illustrated in Examples 2 and 3 can also be triggered by disagreement between two countries as to whether an entity is a taxable person or not (hybrid entity). So, in Example 2, it may be that X is a hybrid entity established by Y.

Country A does not recognise X and so considers the payment is made to Y. Country B does recognise X and considers it to be the recipient of the payment. The tax effects are then the same as discussed in Example 2 above. Similarly, in Example 3, X may be a hybrid entity because Country A considers it to be a taxable person and Country B does not. Again, this may give rise to a double dip deduction as discussed in Example 3 above.

Mismatches of the type illustrated in Examples 2 and 3 can also be triggered by disagreement between two countries as to whether an entity is a resident person or not, as illustrated in Examples 12 and 13. Examples 12 and 13 help to demonstrate that a lot of mismatch tax planning revolves around inconsistencies in the manner in which countries exercise their jurisdiction to tax. What is a 'person' and the fundamental features of the person are important where taxation on the basis of residence is in issue. So, as in Examples 1, 2 and 11, in Example 12 there is a deduction but no effective pickup in taxable income. Similarly, as in Examples 3 and 9, in Example 13 a deduction is granted more than once for the same expenditure (i.e. the expenditure producing the loss). Example 10 is also similar to Example 13 in that the same tax benefit (credit in Example 10 and loss in Example 13) is used more than once.

Example 12
Mismatch as to Residence — Deduction but No Residence Taxation

Z, a resident of Country A, pays for goods bought from Y. Y is formed under the laws of Country A and managed from Country B, but neither Country A nor Country B considers Y as resident in their jurisdiction (different tests of residence). As a result, neither Country A nor Country B taxes Y with respect to the proceeds of sale.

There is a mismatch between Country A and Country B as to the residence of Y. This gives rise to a cross-border tax benefit because the sales proceeds are likely to be deductible to Z in Country A with no pickup in the taxation of Y because it is not resident anywhere (presuming the sale is not attributable to a PE in Country A or Country B, e.g. goods shipped from third country).

Example 13
Mismatch as to Residence - Double Dip Deduction

Z Co is a member of a multinational group of companies. It has been making losses. It is managed from Country A but formed under the laws of Country B. Both Country A and Country B consider Z Co resident in their jurisdiction. As a result, both Country A and Country B provide tax loss relief, including by way of setting Z Co's losses against income derived by other group members resident in their jurisdiction.

There is a mismatch between Country A and Country B as to the residence of Z Co. This gives rise to a cross-border tax benefit because the losses of Z Co are simultaneously used to reduce the income of more than one member of the corporate group.

1.2 What is covered by OECD Action 2

Categorisation of hybrid mismatch arrangements in the OECD's Action 2 Discussion Draft ('OECD Draft') is very different from the above categorisation. This is because Action Plan 2 is targeted at only some types of cross-border mismatch arrangements that may give rise to cross-border tax benefits. In particular, Action 2 only targets hybrid instruments and entities.[13] So it is limited in scope to 'hybrid financial instruments and transfers', 'hybrid entity payments' and 'imported mismatches and reverse hybrids'.[14] It seems an overstatement for the OECD to suggest that '[t]hese categories describe, in general terms, the various ways in which a hybrid technique can be used to engineer a mismatch in tax outcomes'.[15] As the discussion above at 6.1 illustrates, 'hybrid mismatch arrangements' need not be limited to these categories.

1.2.1 Hybrid mismatch arrangements

While the OECD Draft does not comprehensively define 'hybrid mismatch arrangement', it does outline the key elements of such an arrangement. Those elements are:

A. The arrangement results in a mismatch in the tax treatment of a payment
B. The arrangement contains a hybrid element
C. The hybrid element causes a mismatch in tax outcomes
D. The mismatch in tax outcomes lowers the aggregate tax paid by the parties to the arrangement[16]

There is no attempt to separately define 'hybrid', 'mismatch' and 'arrangement', but it seems the OECD views at least the first two in a similar fashion as discussed in the introduction to this paper. In particular, 'hybrid' clearly focuses on two countries viewing the same income tax fundamental in a different way, and 'mismatch' only focuses on outcomes that are beneficial to the taxpayer (and not those that might result in double taxation).

There is little discussion as to the scope of 'arrangement' in the OECD Draft, and the matters covered by the Draft are restricted in a number of manners. The OECD does not intend that 'arrangement' cover all dealings that can have a tax effect. One major difficulty with the Draft is identifying what it intends to cover and what it does not. In particular, it seems that 'payment' is a critical feature of the scope of the Draft and then only payments involving hybrid financial instruments and hybrid entities.

The OECD Draft is concerned with two key mismatches; deduction / no inclusion ('D/NI') outcomes and double deduction ('DD') outcomes.[17] These outcomes are not comprehensively defined and can lead to confusion. First, it is not clear whether an amount must be wholly deductible or included or whether an apportionment approach should be adopted. While subsequent discussion makes it clear that an apportionment is envisaged,[18]

13 OECD (2014) para. 18.
14 OECD (2014) Chapters IV, V and VI, respectively.
15 OECD (2014) para. 50.
16 OECD (2014) pp. 8-10.
17 OECD (2014) para. 20.
18 OECD (2014), e.g. at paras 87, 108 & 245.

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

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

> intended to refer to an item of expenditure that is taken into account... in calculating the taxpayer's net income. The definition includes "equivalent tax relief" in order to cover relief that is economically equivalent to a deduction such as a tax credit for dividends paid.[19]

The discussion continues in a similar vein with respect to amounts treated as 'ordinary income'.[20] It is clear that the Draft covers amounts that are directly deducted or included in calculating income. However, a payment might have an indirect effect, such as where it is included in the cost of an asset or received with respect to a liability. Such amounts may be recognised over the life of an asset or liability or when a transaction occurs with respect to the asset or liability. It is not clear whether the Draft is intended to cover these types of indirect amounts (and see below regarding timing).[21]

Despite a focus on D/NI and DD outcomes, 'Action 2 is not intended to capture all arrangements that have the effect of lowering the aggregate tax burden of the parties to an arrangement.'[22] The problem is that the OECD Draft is not focused on lower taxation as such, but mismatches leading to lower taxation.[23] The Draft recognises that some countries may intentionally create a mismatch that is 'economically closer to a tax exemption or similar taxpayer specific concession'. It seems that such intentional mismatches are not 'tax outcomes in the sense contemplated by Action 2.'[24] This seems an impossible distinction to administer and there is no further discussion of it in the Draft. There are many circumstances in which countries that are viewed as financial centres create intentional mismatches for exemption or concessionary purposes. It is not clear how a country would be expected to identify these and whether one country is expected to respect the intentions of another country.[25]

This lack of focus on tax burden means that the relationship between Action 2 and the general use of low tax jurisdictions is unclear, or at least is not specifically addressed in the OECD Draft. As noted above, the effect of a hybrid mismatch arrangement can be similar to using an intermediary in a third country (triangular arrangement). For many decades, tax planners have used companies in third countries to change the allocation, timing,

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19 OECD (2014) para. 92.

20 OECD (2014) para. 94.

21 For example, a company buys an asset from a foreign shareholder and pays 100 for it. The state of the company recognises the full 100 as the purchase price. The state of the shareholder considers the purchase price is 70 and that the remaining 30 is a dividend, which it exempts (e.g. participation exemption). Subsequently, the company sells the asset at a loss and claims a deduction for it. Is this arrangement caught by a D/NI rule?

22 OECD (2014) paras. 22.

23 Boidman & Kandev (2014) pp. 1234-1235 make a similar point.

24 OECD (2014) para. 22. The example given is where a country has created a specific deduction 'for invested equity' as under an allowance for corporate equity ('ACE') system. As to the ACE system, see Institute for Fiscal Studies (1991) and Mirrlees, Adam, Besley, et al (2011) pp 421-5.

25 For example, would a general deduction for dividends such as can arise in Australia for redeemable preference shares with a term of less than 10 years be something that another country can neutralise or not? Are the OECD proposals only intended to apply where there is a mismatch in the character of the financial instrument or entity? If the latter approach is adopted, it would drive a large hole through the impact of the OECD proposals.

quantity and character of payments ultimately passing from the jurisdiction of the investment to the jurisdiction of the investor. The novelty of hybrid mismatch arrangements is that they can do this without the use of a third country (even though they often do involve third countries).[26] Because intermediaries and hybrid mismatch arrangements are being used in the same manner, it may be suggested that rules designed to regulate them should be developed together to ensure a consistent treatment (see below at 6.4.4). There is no evidence of this in the OECD Draft.

The OECD Draft also does not 'address differences in the timing of payments', although it is not exactly clear what this means.[27] What is clear is that a timing difference of the type identified in Example 5 above would not be covered.[28] So while a timing mismatch under an 'original issue discount' is not covered, strangely, however, one example provided in the Draft covers a timing mismatch under a deferred purchase price agreement.[29] Beyond that there are other difficulties. In particular, at one level, the difference between an immediate deduction of an amount on an accrual basis and the inclusion of an amount in the cost base of an asset is a question of timing, i.e. accrual versus realisation of the asset. Similarly, an amount received may be immediately included in income or it may represent an amount that will only be brought into account on a transactional basis, e.g. when a liability with respect to which the amount is received is disposed of. It is not clear how the Draft is meant to deal with, for example, issues of double dips through simultaneous deduction of an amount and inclusion in the cost base of an asset.

The OECD Draft contains virtually no mention of quantification issues. Perhaps this is because Actions 8, 9 and 10 are intended to deal with transfer pricing issues. The draft does make a difficult distinction between 'differences in the way jurisdictions measure the value of money paid under a financial instrument' and 'differences in the amount attributable to a financial instrument if the difference is attributable to differences in the value of the payment (as calculated in money).'[30] The intention seems to be to differentiate between foreign exchange movements (not covered) and differences in valuing a discount (covered). There seems little conceptual basis for making such a distinction (and the question arises whether it is practical to make one).

There are points at which the Draft deals with the bifurcation of an amount into two parts of a different character, e.g. revenue and capital.[31] However, this is a matter of identifying a particular payment (as opposed to two payments) and characterisation. It is not a matter of pure quantification. Again, the Draft does not draw connections in this regard or expressly coordinate with Actions 8, 9 and 10.

While there is some uncertainty as to the scope of Action 2 in the OECD Draft, it is supported with 21 worked examples ('Figures') which reveal much about the scope of the Draft. Box 1 is an attempt to categorise the OECD examples by reference to the

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26 Harris & Oliver (2010) pp. 369-70.
27 For example, see OECD (2014) para. 26.
28 OECD (2014) para. 88.
29 Figure 5, OECD (2014) p. 36. The amount immediately deducted in Country B will be picked up should B Co sell the asset (because the deduction reduces the asset's cost base). This is not much different to the tax effect of accelerated depreciation (e.g. a first year allowance), which presumably is not covered by the OECD Draft.
30 OECD (2014) paras 89 & 90, respectively.
31 For example, see Figure 19, OECD (2014) p. 73, where the bifurcation is between financing expense and purchase price (discussed further below).

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

Box 1
Categorising Hybrid Mismatch Examples

Payments

Identification

Example 1

Allocation of Recipient

Example 2

Allocation of Payer

Example 3

Quantification

Example 4

Timing

Example 5

Character

Example 6

arning Activities and Provision of Resources

Identification of Earning Activity

Example 7

Threshold of Earning Activity

Example 8

Ownership of Asset

Example 9

OECD Figure 2, Collateralised Loan Repo

OECD Figure 3, Bond Lending Repo

OECD Figure 19, Collateralised Loan Repo

OECD Figure 20, Share Lending Repo

Character of Asset

Example 10

OECD Figure 1, Hybrid Financial Instrument

OECD Figure 4, Hybrid Financial Instrument with Tax Exempt Holder

OECD Figure 5, Right to Deferred Purchase Price

OECD Figure 12, Importing Mismatch from Hybrid Financial Instrument

OECD Figure 16, Foreign Tax Credit Generator Transaction involving use of Hybrid financial instrument

Persons and Personal Characteristics

Identification

Example 11

OECD Figure 6, Double Deduction Structure Using Hybrid Entity

OECD Figure 7, Double Deduction Structure Using a PE

OECD Figure 9, Disregarded Payments Made by a Hybrid Entity to a Related Party

OECD Figure 10, Disregarded Payments Made by a Permanent Establishment

OECD Figure 11, Payment to a Foreign Reverse Hybrid

OECD Figure 13, Tower Structure

OECD Figure 14, Conflict in Characterisation of Payee and Payer

OECD Figure 15, Application of Hybrid Financial Instrument and Hybrid Entity Payment Rule

OECD Figure 17, Payment to a Branch in Same Jurisdiction as Payer

OECD Figure 18, Payment to a Branch Located in an Intermediate Jurisdiction

Residence of Recipient

Example 12

Residence of Payer

Example 13

OECD Figure 8, Dual Consolidated Companies

OECD Figure 21, Payment by a Partnership to a Partner

The OECD Draft contains no pure examples of mismatches with respect to payments, only such mismatches triggered by mismatches as to allocation and character of assets and identification of persons. The OECD examples focus on mismatches as to ownership of assets, character of assets, identification of persons and dual residence. This raises fundamental questions as to whether any other types of mismatches are intended to be covered (it seems that at least some are). Further, this is not to suggest that the OECD Draft intends to cover all mismatches that fall within these categories and, in particular, the OECD examples are essentially limited to secondary mismatches as to payments. And then the OECD examples are largely limited to mismatches as to character of a payment and allocation of maker and recipient.[32] The OECD examples are further analysed below at 6.4.5.

1.2.2 Hybrid financial instruments and transfers

A primary focus of the OECD Draft is on mismatches in the character of a payment made under 'financial instruments'. The Draft covers both pure mismatches in the character of a payment (even where there is no mismatch in the character of the asset with respect to which the payment is made) as well as such mismatches that are triggered by a mismatch in the character of the underlying asset.[33] The former are apparently covered despite no example being dedicated to it, i.e. all OECD examples as to mismatches as to the character of a payment are triggered by other mismatches such as the character of a financial instrument asset or allocation of its owner.

While 'financial instrument' seems a limiting factor in the OECD Draft, there is no effective definition of that phrase. Rather, it is recommended that this be determined by reference to domestic law.[34] It may be presumed that many countries will adopt a definition consistent with that used for financial reporting purposes. For example, the definition used in the International Financial Reporting Standards is a particularly difficult and complex definition.[35] While financial instruments should be a primary target, it is not clear that anti-mismatch rules should be limited by the concept of 'financial instrument'.[36]

Two countries may not agree as to whether an arrangement is a financial instrument, and this will give rise to a different sort of mismatch. This could particularly be a problem with respect to leases, which may be viewed as a finance lease by one country (and so a financial instrument), but viewed as an operating lease by another (and so not a financial

32 Athanasiou (2014a) notes that the OECD's Business and Industry Advisory Committee considers 'the rules are both broad and underinclusive.'

33 Compare Examples 6 & 10 above with Figures 1 and 19 in the OECD Draft; OECD (2014) pp. 19 & 73.

34 OECD (2014) p. 25, which suggests that the domestic law should 'at least include anything that is treated as a debt or equity... also, arrangements that taxpayers use as alternatives to debt and equity...' Also see para. 105.

35 International Accounting Standard 32 para. 11. The IASs are available at http://www.ifrs.org/IFRSs/Pages/IAS.aspx (accessed 12 July 2014).

36 A common reason giving rise to a mismatch in tax law characterisation of a financial instrument is because either or both countries do not follow financial reporting standards for purposes of distinguishing debt and equity. Some view blindly following accounting standards in tax law as potentially harmful, e.g. Harris (forthcoming). A tax law definition of 'dividend' may include payments that are not directly related to 'financial instruments', at least not for financial reporting purposes (e.g. some types of constructive dividend). It is not clear whether such payments are covered by the OECD proposals.

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

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

1.2.3 Hybrid entity payments

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

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

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

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

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

38 Figures 2, 3, 5 & 20; OECD (2014) pp. 21, 23, 36 & 74, respectively. The OECD Draft is clear that while this type of mismatch often involves shares of controlled entities, 'virtually any asset that generates' some form of tax relief can be used; para. 66.

39 OECD (2014) p. 44.

40 OECD (2014) p. 48.

41 For example, in OECD Figure 9, Country B sees the head office of A Co (or A Co less B Co) as an entity separate from B Co and so sees the head office as the recipient of the payment. By contrast, Country A does not see the head office as separate from the rest of A Co (B Co being considered part of A Co), making the head office a hybrid entity.

42 Any suggestion that one country does not see the payment received is countered by the equal observation that one country does not see the payment made. Hence, this second type either involves both a hybrid entity payment and a reverse hybrid mismatch or neither.

43 OECD (2014) p. 45.

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

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

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

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

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

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

45 OECD (2014) p. 49.

46 OECD (2014) p. 47.

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

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

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

1.2.4 Reverse hybrid and imported mismatches

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

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

This causes the OECD Draft to turn (in the same Part) to what it calls 'imported mismatches', which are 'hybrid structures created under the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction.'[54] The connection between 'reverse hybrids' and 'imported mismatches' is not clear, at least from a conceptual perspective.[55] Inevitably, any form of hybrid mismatch arrangement can arise in the context of three or more countries. Issues raised through the use of an intermediary state seem to be little more than the usual issues pertaining to treaty shopping and tax havens. The Draft incorporates little explanation of the relationship between hybrid mismatch arrangements and these issues of treaty shopping and the use of tax havens.[56]

A subsequent example (Figure 18) in the OECD Draft demonstrates two further points - that a hybrid mismatch can be 'imported' into a recipient state through an intermediate

[50] OECD (2014) p. 56.
[51] OECD (2014) para. 201.
[52] Harris & Oliver (2010) pp. 388-89.
[53] OECD Commentary on Art. 4 para. 8.8, although this comment is made in the context of hybrid partnerships. See also Harris & Oliver (2010) pp. 63 and 348.
[54] OECD (2014) para. 206.
[55] OECD (2014) para. 216 attempts to explain the connection. Paragraph 217 explains the 'difference between reverse hybrids and imported mismatch arrangements... as a difference between direct and indirect mismatches'. This seems a virtual non-distinction and to say little more than that the latter involves a third country and the former need not. The same could be said with respect to other (non-reverse) types of direct hybrid mismatch arrangements.
[56] OECD (2014) para. 209 notes that an intermediate jurisdiction will have 'little incentive' to introduce rules to neutralise hybrid mismatch arrangements.

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

1.3 How OECD Action 2 proposes to deal with the problem

1.3.1 General Approach

The OECD Draft lacks detail in identifying and classifying hybrid mismatch arrangements and, as a consequence, its suggested response to these arrangements seems somewhat disjointed. Difficulties with the approach suggested in the Draft are revealed in its Table 1, which sets out a summary of the recommendations.[59] The recommendations are a patchwork of highly specific rules that at points appear almost random and which are likely to be highly complex in detail in domestic implementation. Implementation may involve high compliance costs and potentially facilitate tax planning involving the technical details of what is covered by one country and what is covered differently by another country. A comprehensive resolution to hybrid mismatch arrangements seems unlikely.[60]

The OECD Draft contains no general response, but rather targeted rules with different outcomes. Complex detailed definitions will be necessary with respect to each cell in Table 1 of the Draft, with the consequent likelihood of difficult issues about whether a particular arrangement falls within one cell, another cell, more than one cell or within no cell at all.

Defining Scope: Columns 1, 2 and 3 of Table 1

Table 1 is structured around four primary rows, which reflect the categories of hybrid mismatch arrangements discussed under heading 6.2. These categories appear in the first column although reverse hybrids are separated from imported mismatches reflecting the lack of connection between these categories as discussed above at 6.2.4.

The second column in Table 1 seeks to identify the hybrid element to be addressed. It may be presumed that this element is a restriction on the category and so will require definition. For example, it seems that the rules for the first category are not only limited by reference to hybrid financial instruments and transfers (which require definition) but only apply where such an instrument produces differences in the characterisation of a payment under the instrument. This requires additional definitions such as 'payment' and 'characterisation'. Of itself, it seems that this category does not cover differences as to allocation, quantification and timing of a payment although in some cases it may be difficult to distinguish these from differences as to character.

57 OECD (2014) p. 72.
58 For example, see Harris & Oliver (2010) pp. 353 & 389-91.
59 OECD (2014) p. 18.
60 Regarding the patchwork nature of the OECD proposals and particularly regarding difficulties for developing countries, see Johnston (2014).

However, care must be taken because the detail as to the hybrid element in Table 1 is not consistent with the detailed recommendations in the body of the OECD Draft for Category 1. So, for example, while Table 1 seems to limit the first category by reference to the character of payments, this is not obviously a limitation in the body of the recommendations.[61] Rather, the focus is purely on whether a payment is D/NI. This creates unnecessary uncertainty as to the types of mismatches covered by the first category.

There are similar difficulties with the hybrid element for Category 2 in Table 1 (hybrid entity payments). Table 1 again suggests that the hybrid element in the hybrid entity payments category is limited to characterisation of payments. There is no such limitation in the detailed recommendations. Further, Table 1 refers to the treatment of the entity or 'arrangement' making it unclear as to whether this category is intended to extend beyond differences caused purely by the nature of hybrid entities. There is further confusion when the detailed recommendations are turned to. These don't mention 'hybrid entity payments' at all, but only 'hybrid payments'.[62]

The relationship between the hybrid element in Categories 3 and 4 of Table 1 and the detailed recommendations is more disjointed. Here there is only reference to the tax treatment and no reference to an entity, despite all the discussion in the OECD Draft being with respect to entities. This is not helped by a consideration of the detailed recommendations.[63] Unlike Table 1, these recommendations do not distinguish between reverse hybrids and imported mismatches (and the title puts them in reverse order). Further, and unlike the other detailed recommendations, there is a distinct lack of definitions in the detailed recommendations for reverse hybrids and imported mismatches. At first glance, it appears the detailed recommendations in the different categories were not drafted according to a uniform format.

The third column in Table 1 identifies the type of mismatch in the D/NI and DD formats. As discussed above at 6.2.1, it is not precisely clear what is meant by a deduction or inclusion in income. Some amounts, like those included in the cost base of an asset, are included in an amount that is then deducted or included in income. Some amounts have deferred recognition. Some amounts are not quantified the same. Some amounts can result in D/NI despite all the fundamental feature of a cross-border payment being agreed by both countries. These are all matters that require further consideration.

Nature of Recommendations: Columns 4 and 5 of Table 1

The next two columns in Table 1 are interesting, especially by comparison with tax treaties. These columns move beyond identifying the scope of application and move to the content of the recommendations. Many of the problems caused by hybrid mismatch arrangements are not regulated by tax treaties, i.e. tax treaties contain gaps and do not deal with them.[64] Rather than seek to develop tax treaties more fully through changes to its Model, the OECD proposes other recommendations for dealing with the identified hybrid mismatch arrangements. These recommendations are of two types.

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61 In particular, see paragraph e) in the box at OECD (2014) p. 25.

62 OECD (2014) p. 51.

63 OECD (2014) p. 61.

64 Generally, see Harris & Oliver (2010) pp. 345-68.

The fourth column in Table 1 incorporates recommendations for changes to the domestic law of countries. These are suggestions for unilateral action. There is some uncertainty as to precisely what is being recommended. For example, it is not clear whether the recommendation to deny a dividend exemption for a deductible payment only applies where a mismatch with respect to a hybrid financial instrument or transfer is involved. If the recommendation is generally applicable then it doesn't really belong in the first category (or any of the other categories). The detailed recommendations are no clearer.[65] In any case, the recommendation is too narrow and should also cover dividend relief by way of granting dividend tax credits. The two other recommendations for unilateral action appear quite random and relate to broader issues that are not discussed in the OECD Draft.[66]

The fifth column in Table 1 contains the so called 'linking rules'. Here it is still intended that countries adopt the rules unilaterally, but the unilateral rules will integrate with and be dependent on rules in other countries. In the past decade and a half there has been a steady increase in unilateral rules (outside granting foreign tax relief) that depend on tax treatment in another jurisdiction, especially with respect to hybrid mismatch arrangements. The difference in the OECD Draft is that an international organisation is recommending coordination of this specific set of rules. Historically, this sort of coordination in the tax field has been reserved for treaties.[67] This seems a fundamental shift in approach by the OECD and sits questionably with the OECD recommendations of what should appear in tax treaties, i.e. the OECD Model tax treaty.[68]

The fifth column in Table 1 contains three sub-columns; primary response, defensive rule and scope, but the latter seems to be further limitations on ('exceptions' to) the application of the rule. The approach is that one state is the primary state for responding to a mismatch, with a secondary state responding only if the primary state fails to act. This coordination is to 'stop the potential for double taxation'.[69] The OECD proposals seem to be particularly concerned with the potential that anti-hybrid rules might produce double taxation and avoiding this seems to be a source of much complexity in the proposals.[70] This is consistent with the OECD's approach to transfer pricing,[71] but not with respect to economic

65 See paragraph c) of the box at OECD (2014) p. 25. For example, if the recommendation is generally applicable it might suggest denial of a dividend exemption for an amount that was deducted due to an allowance for corporate equity or Brazil's interest on net equity system, see discussion above at 6.2.1. Paragraph 114 suggests that 'it has not been considered necessary to limit the scope of this recommendation'.

66 For example, the recommendation with respect to withholding tax credits is suggested to specifically address the repurchase transaction illustrated in Figure 2, OECD (2014) p. 25. However, as explained above at 6.2 in the context of losses, the problem is more fundamentally in preventing the simultaneous granting of a tax benefits in more than one jurisdiction. Similarly, the recommendation with respect to filing and provision of information in an intermediate state seems inextricably linked to collection and exchange of information generally.

67 As Ault (2013) p. 1196 predicted, the OECD approach may be viewed as a development of 'some of the ideas in the OECD partnership report', see OECD (1999).

68 Harris & Oliver (2010) p. 467 suggest that a major question and challenge for the international tax 'system' in this century is whether the 'old system of bilateral tax treaties... will be abandoned in favour of an intentionally structured system designed to best deal with modern situations or whether the new system will develop as a set of ad hoc rules with a loose attempt at coordination.'

69 OECD (2014) para. 52.

70 For example, see OECD (2014) para. 33.

71 See the corresponding adjustments in Articles 7(3) and 9(2) of the OECD Model.

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

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

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

1.3.2 Actions by payer/source/host state

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

In the context of D/NI types of mismatch for both hybrid financial instruments and transfers and hybrid entity payments the OECD recommends that the state of the payer is the primary state. Accordingly, this state will deny the payer a deduction for the payment made that is not included in the income of the recipient. In the context of hybrid financial instruments and transfers, this is subject to the general recommendation that the state of the recipient unilaterally deny a dividend exclusion or exemption for any amount that is deductible in the state of the payer. It seems that this rule is intended to apply in priority to the rule for the state of the payer to deny a deduction.[77] However, neither the unilateral denial of a dividend exclusion or exemption nor the denial of a deduction in the payer state seems to

72 The OECD Model has no provision for underlying foreign tax relief and does not resolve the potential for double taxation through the simultaneous application of CFC rules by more than one country. Generally, see Harris & Oliver (2010) pp. 291 & 303.
73 For example, see Harris (2013a) pp 198-204.
74 Traditionally, the allocation of international taxing rights has been guided by 'source country entitlement' (first entitlement to tax), although this principle more clearly underlines the UN Model tax treaty than the OECD Model tax treaty. Generally, see Harris & Oliver (2010) pp 103-5.
75 For example, OECD (2014) para. 27, subpara. (a).
76 OECD (2014) para. 117.
77 For example, OECD (2014) paras 113 to 116.

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

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

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

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

Not only are the concepts of 'disregarded payment' and 'dual inclusion income' difficult to understand, but they instil little confidence that they are balanced and robust against abuse. For example, it is possible that the income of a related party against which the deduction is set is 'dual inclusion income' (also taxable in the residence state or another state). However, that does not appear to count because it is only the 'taxpayer's dual inclusion income' that counts. Further, it is the whole of the taxpayer's dual inclusion income that counts irrespective of whether the deduction is actually set against that income. For example, presume that the taxpayer has other income that is taxable in the source state by way of low withholding tax that is also taxable in the residence state (with foreign tax credit). If the deduction claimed is transferred to another source state group member but does not exceed the income subject to withholding tax, would the primary rule still apply?[84]

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78 See the example below at footnote 90.

79 OECD (2014) paras 96-102.

80 Paragraph e) of the box at OECD (2014) p. 25.

81 Paragraph a) of the box at OECD (2014) p. 25.

82 OECD (2014) para. 103.

83 Paragraph h) of the box at OECD (2014) p. 51.

84 This may be countered by the discussion at OECD (2014) para. 187, but that is not clear. A further question with respect to dual inclusion income is whether it will include the profits of a subsidiary that will be taxable when a dividend is distributed to a parent company.

The exceptions in the payer state for D/NI mismatches with respect to hybrid financial instruments and transfers and hybrid entity payments are broadly the same. The OECD intends the rules to always apply in the context of 'related parties', 'persons acting in concert' and 'structured arrangements'. Definitions are provided for the first two of these concepts.[85] While these concepts are broadly familiar to concepts used in most countries' tax laws, integrating them properly with those local concepts may not be straightforward. It is also suggested that widely held instruments and entities should be excluded from the rules and potentially there will be special rules for 'hybrid regulatory capital'.

DD mismatches for hybrid entity payments and D/NI mismatches for reverse hybrids and imported mismatches

In the context of DD types of mismatch for hybrid entity payments and D/NI mismatches for reverse hybrids and imported mismatches the OECD recommends that the host state is the secondary state. One reason for this may be because, for the host state, the expense (payment) is likely to have been incurred in deriving domestic source income. By comparison, for the investor state the expense is likely to have been incurred in deriving foreign source income (hybrid entity payment) or be foreign income. This reversal of roles of the host and investor states as the primary state raises critical questions as to the allocation of expenses between domestic and foreign activities (although the OECD Draft makes no reference to this). This is returned to under heading 6.4.

In the context of hybrid entity payments, the host state, as the secondary state, must investigate whether a deduction was granted in the investor state and, if so, deny a deduction for the expense (payment). Again, this may be particularly difficult to administer, not only in terms of finding out what happened in the investor state, but also in characterising it. For example, will the secondary rule apply if the investor state considers that the payment was for the acquisition of an asset and then grants depreciation for that payment? What if the investor state does not offer a deduction but grants some other form of tax relief such as an investment credit?[86]

Further, the secondary rule is qualified by reference to the concepts of 'dual inclusion income' and 'hybrid payments', as discussed below at 6.3.3 in the context of the primary rule. Further, there are similar rules for carry forward of denied deductions and stranded losses as discussed at that point. The complexity of applying these rules may verge on impossible for many tax administrations.

In the context of reverse hybrids and imported mismatches, the host (payer) state must investigate whether the payment was included in calculating income in the investor state or any intermediate state. If not, the host state is to deny a deduction for the payment. Again, the level of coordination in not only looking to the investor jurisdiction but through potential intermediaries in potentially uncooperative third countries could be substantial or impossible for many tax administrations.

The exceptions for the application of the secondary rule in the host state are the same as for the primary rule in the case of hybrid entity payments, but the exceptions in the case of reverse hybrids and imported mismatches are different again. The rules for reverse

85 OECD (2014) pp. 34-35.
86 Other forms of relief may be covered by the 'equivalent tax relief' concept, discussed above at 6.2.1.

hybrids and imported mismatches are only to apply to members of a 'controlled group'. This is defined in terms of '50% or more commonality of ownership'.[87] It is not clear whether an individual can be a member of a 'group'. The rules are also to apply to 'structured arrangements' but countries are invited to provide some 'safe-harbours', which are not specified.[88]

1.3.3 Actions by investor/residence/home state

In the context of D/NI types of mismatch for both hybrid financial instruments and transfers and hybrid entity payments the OECD recommends that the state of the investor is the secondary state. As such, it must determine whether the payer state denied a deduction for the payment under the primary rule before deciding to include an amount in the recipient/investor's income. As noted above, this is subject to the rule that the investor state refuse a dividend exemption for any deductible payment.

As previously explained, mismatches may also arise even where the investor state includes the receipt of the payment in the investor's income if that state grants some type of relief with respect to the payment. Tax credits (whether foreign tax credits or dividend tax credits) are one example. The OECD Draft contains an additional rule pertaining to the granting of foreign tax credits. An investor state should limit foreign tax credits for source state withholding tax 'in proportion to the net taxable income under the arrangement'. However, this rule seems to be limited to hybrid transfers of financial instruments.[89] In any case, it seems particularly narrow and is unlikely to resolve the problem of duplicating credits.[90]

In the context of DD types of mismatch for hybrid entity payments and D/NI mismatches for reverse hybrids and imported mismatches the OECD recommends that the investor state is the primary state. In the DD case the investor state is to deny a deduction for the expense and in the D/NI case it is to include the amount in the income of the investor.

As with D/NI mismatches for hybrid entity payments, the DD case is subject to an additional qualification - the dual deduction can be claimed to the extent it does not exceed 'the claimant's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions)'.[91] Again, this triggers the definition of 'dual

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87 OECD (2014) para. 232.
88 OECD (2014) paras 234-236.
89 OECD (2014) para. 82.
90 For example, the UK often grants both direct foreign tax credits and dividend tax credits when an individual receives foreign dividends (largely as a result of decisions of the Court of Justice of the European Union). When a New Zealand company distributes a dividend to a foreign shareholder it must withhold tax. However, that tax can be credited against the company's own tax liability. So when a dividend is distributed by a New Zealand company to a UK individual, multiple credits may be granted; one to the New Zealand company and two others to the UK individual, who will also be entitled to the lower tax rate applicable to dividends. Generally, see Harris (2013) pp. 350-51 & 377-78. It seems the OECD Draft recommends nothing to deal with this sort of duplication, even though shares are a financial instrument. Similarly, if a UK individual receives dividends paid by a Brazilian company entitled to deduct part of the dividend the individual will still receive a dividend tax credit and the benefit of the lower dividend tax rates in the UK. This type of mismatch also seems to fall outside the OECD recommendations.
91 OECD (2014) para. 181 and paragraph d) of the box at p. 51.

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

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

1.3.4 Actions by intermediate state

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

1.4 Other steps that may be taken

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

[92] For example, see OECD (2014) para. 196.
[93] OECD (2014) para. 207. Boidman & Kandev (2014) p. 1244 refer to this as 'plainly utopic'.
[94] Paragraph b) of the box at OECD (2014) p. 61.
[95] Such as the examples at OECD (2014) paras 237-240, some of which involve situations where two countries disagree on the identity of both the payer and the recipient of a payment.
[96] OECD (2014) para. 27.
[97] 'Foremost among stakeholder concerns during this process has been the fear that administration of the rules and coordination among jurisdictions, as well as with other base erosion and profit-shifting initiatives and domestic law, will be prohibitively difficult, leading to double taxation, competitive inequities, inefficiencies, and impossible compliance burdens.' Athanasiou (2014b) p. 1083.
[98] OECD (2014) para. 33.

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

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

The level of coordination required between countries for implementation of the OECD recommendations is unprecedented. The recommendations are prescriptive as to domestic tax law amendments in a manner not seen before. Further, the recommendations require a country to investigate not only the terms of a financial instrument or entity and the tax treatment of it under the tax law of another country,[103] but the country might also need to investigate the relationship between each party to a payment and sometimes (as in structured arrangements) their motives.[104] Coordination between countries and responding to anti-avoidance is not new. What is new is the intensity of the focus and the lack of clarity in what is trying to be achieved. 'Neutralising' is no guiding principle without specifying a comparator or context, i.e. neutralised by comparison to what.

Many countries will look for simpler ways of addressing hybrid mismatch arrangements, particularly if they can be coordinated more generally with measures to prevent base erosion and profit shifting.[105] In order to identify other options, it is necessary to return to basics to identify the core of the problem. After all, financial instruments and different types of entities are not the problem; they are only vehicles that are used to exploit flaws in tax fundamentals. Those tax fundamentals need to be investigated to see what can be done.

1.4.1 Step back: The bigger picture

The core structural problem that hybrid mismatch arrangements demonstrate is the mixing of source and residence tax bases. Historically, most income tax laws in Europe

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99 Paragraph d) at OECD (2014) para. 27.

100 Ault (2013) at p. 1199 doubts that 'the rules dealing with the BEPS issues can be structured so accurately that they hit only the desired targets and there will inevitably be situations when undesirable double taxation could arise'.

101 OECD (2014) para. 241.

102 OECD (2014) para. 242.

103 Even for a residence country, Lüdicke (2014) p. 313 suggests that knowledge about foreign taxes for purposes foreign tax credit and CFC rules 'seems easier' and requires 'less technical understanding about the foreign tax rules' than knowledge required to implement the OECD proposals.

104 Athanasiou (2014a) quotes Ernst and Young as saying '[a]pplying different rules to several categories of hybrid arrangements is "more complicated than any domestic law regime of any country in place today"'.

105 Athanasiou (2014a) also notes that the issues covered by Action 2 'overlap with a number of other BEPS actions'.

developed from separate taxes on the basis of source that were subsequently supplemented with a general tax on the basis of residence. The taxes on source and those on residence were quite distinct.[106] It was from this basis that the first tax treaties evolved, which not surprisingly incorporated a schedular approach.[107] This was not the case in the UK and the US, which had general income taxes. Even though the categorisation of income might have been schedularised, under a general income tax all income of a resident (foreign or domestic) is taxed at the same rate and domestic source income of non-residents is also taxed. This mixed or fused general income tax causes overlapping jurisdictions to tax. As the 20th century progressed, most countries moved to a mixed system.

Unlike earlier schedular source taxes with a supplementary residence tax, the mixed system provides no obvious allocation of taxing rights between countries. The allocation subsequently developed was based on tax treaties. As the OECD Model demonstrates, tax treaties produce an uneven, somewhat random, schedularised source based tax. This is then overlaid with a residual tax in the residence state that is subject to the provision of foreign tax relief. Wherever the source tax rate and the residence tax rate are different, this system facilitates *gaming* between different types of income. At one level, hybrid mismatch arrangements facilitate this gaming as one country thinks that income falls into one category and the other thinks that it falls into another.

Historically, residence based taxes worked in an overarching fashion that attempted to ensure 'equity' between particular residents and in doing so would often remove some of the benefits of gaming. The countries from which most investment derived were often comparatively high tax countries and this facilitated the protection role of residence based taxes. When residence based taxes began to be seriously challenged by deferral through third country holding company structures, many 'investor' countries implemented anti-deferral rules such as CFC rules. That was manageable where the ultimate investor was clearly within the jurisdiction. Often that is not the case anymore.

Globalisation and the information age have made fragmentation of investment in artificial entities both easy and lightning fast, and this has made taxation purely on the basis of corporate residence inherently problematic. It is now common for persons resident in many countries to hold shares directly in multinational entities that derive income from many different countries. Any attempt by one country to impose any substantial tax on such a multinational entity purely on the basis of corporate residence (tax foreign source income) is likely to cause the entity to move its residence, which is not a difficult matter. And in many cases, not taxing on the basis of corporate residence is appropriate. Why should a country tax foreign source income of a resident corporation if the majority of its shareholders are foreign or tax exempt (e.g. pension funds)?

Ensuring balanced taxation in the source state is a different matter and perhaps this is where the focus of attention with respect to hybrid mismatch arrangements and other base erosion and profit shifting efforts should be. Many source states care little about where investment comes from and, in any case, have little control over that. They care little whether the ultimate investor is some taxable entity or a non-taxable entity. Often source states even care little whether an investment is from a high tax country, a financial centre or a

106 For example, see Harris (1996) pp. 73-88 and 286-300.

107 Harris (1996) pp. 286-306. The difference between schedular taxes on different sources of income and a complimentary comprehensive income tax on the basis of residence is evidence in some of the early League of Nations' model tax treaties.

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

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

1.4.2 Joint steps: Separating source and residence tax bases

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

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

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108 For example, Boidman & Kandev (2014) p. 1237 note that 'historically, tax law design has not conditioned deductibility of payments on their tax treatment for the recipient. If a source country wishes to reduce the level of tax incentives provided to inbound investors, it can simply tighten the deduction limitations already in place.'

109 Edge (2014) p. 319 suggests that as a matter of fairness 'businesses should be treated equally within the jurisdiction in which they are operating'.

110 OECD (2014) para. 28.

The source of expenses may be determined in a similar manner as the source of receipts. In broad outline, domestic source income could be calculated as the net of receipts with a domestic source less expenses with a domestic source. Foreign source income could be calculated in a similar fashion.[111] This is a point at which it simply makes no sense to follow financial reporting rules because those rules are designed for global reporting of income. They are totally inadequate for purposes of allocating tax bases between countries.[112] Taxpayers should not be given discretion as to whether foreign expenses offset domestic receipts or domestic expenses offset foreign receipts. It should be a conscious decision for a country, as a policy matter, to permit domestic losses (domestic expenses less domestic receipts) to offset foreign income (foreign receipts less foreign expenses) or foreign losses against domestic income.

1.4.3 Source state steps: Plugging the gaps

Granting a resident entity a deduction for an outbound payment that is not subject to withholding and that does not result in an equal inflow of resources into the country erodes the source country's tax base. These are the types of payments that are the targeted by hybrid mismatch arrangements. They are particularly facilitated by the OECD Model,[113] which presumes that such payments will be picked up by taxation in the residence country of the recipient. However, if residence country taxation of artificial entities is failing in the face of globalisation, this is something that needs to be revisited. There are only two ways to address source state tax erosion - increase the scope and rate of withholding taxes or deny a deduction.

To prevent tax base erosion, source states might seek full and uniform withholding tax on all outbound payments that do not result in an equal inflow of resources into the country.[114] The rates should be sufficient so as to not discourage local provision of the service paid for. Particularly, this can be a problem with the provision of services, where many countries lack substantial withholding taxes. Services are commonly provided by foreigners into a source state through tax havens. The lack of taxation often means that foreigners can undercut the provision of equivalent services by a domestic provider. The same is true with respect to rent payments for the use of mobile assets. In a globalised world, a source state cannot presume that there will be appropriate taxation in the residence state. It is often fair to (and perhaps a source state must) presume that incoming resources will be provided through a tax haven or equivalent (such as a hybrid mismatch arrangement).

Tax treaties are particularly inflexible instruments that give away source state taxing rights, sometimes unwittingly. A number of developing countries with substantial natural resources have concluded tax treaties that can be exploited to erode the country's tax base in

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111 For an example of rules of this nature, see Harris (2000) s. 68. Some of these rules need refinement.

112 See Harris (forthcoming) at 6.6.

113 For example, lack of source state taxation due to limits in Articles 7 (business profits), 11 (interest) and 12 (royalties) and limitations on a source state's ability to deny deductions under Article 24 (non-discrimination).

114 Michael Lennard, the chief of international tax cooperation in the UN Financing for Development Office, has been reported as saying that '[o]ne of the things that is important for developing countries, but that is not in the OECD action plan, as such, is the preservation of withholding taxes generally... I think that one of the outcomes of BEPS will be developing countries will be more and more recognizing the importance of preserving their withholding taxes and in treaties, not giving them away too readily.' Stewart, D. (2014).

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

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

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

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

At a more extreme level, source states might consider introducing or broadening the scope of their earnings stripping rules. Many countries already have rules that deny a deduction for excessive interest. Some of these are based on transfer pricing (borrowing beyond an arm's length amount), debt to equity ratio (thin capitalisation) or earnings stripping (interest beyond a set proportion of pre-financing expense income) methodology.[119] However, interest payments are only one way in which a source state tax base may be eroded.

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115 See OECD (2014) para. 12 which focuses on 'denial of deductions in the payer state and/or forcing the inclusion in the payee state'.

116 Treaties that involve coordination of tax administration do not erode source country taxing rights and do not fall into this category, e.g. the 2011 multilateral Convention on Mutual Administrative Assistance in Tax Matters.

117 For the reasons discussed in OECD (2014b) para. 24, the better view is that such a rule does not breach Article 24(4) of tax treaties.

118 Schön (2014) p. 284 notes the 'asymmetry' in setting foreign expenses against domestic source income.

119 For example, see Hey (2014) particularly at pp 335-36.

In particular, it is possible to modify an earnings stripping approach to cover all types of base eroding payments. The total of deductions granted for payments made to entities with limited tax liability might be restricted to a certain percentage of the value of assets used in an earning activity.[120] Particularly, such a rule might be considered by source states that have already given up substantial taxing rights under tax treaties.[121]

1.4.4 Residence state steps: Don't discourage domestic investment

Deferred or non-taxation in the residence state of foreign income that has been lowly or non-taxed overseas encourages foreign over domestic investment by residents. The only solution to this problem is a foreign tax credit system with anti-deferral rules, e.g. CFC rules. The problem is that these rules need to be carefully crafted or they may discourage foreign investment into a country, at least where that foreign investment may bring with it a need or potential for deriving third country income. In this context, it is natural for countries that are or wish to be financial centres to resist the adoption of (or erode existing) CFC rules. As noted above at 6.4.1, if the ultimate investor is a non-resident or tax exempt then CFC rules are distorting (as to location and form of investment). If the ultimate investor is a local wealthy individual, then the lack of CFC rules is distorting. This suggests a need for investigating the better targeting of CFC rules at this latter category.[122]

A number of the recommendations in the OECD Draft sit uncomfortably with OECD past practice with respect to CFC rules. As noted above at 6.3.3, a number of the recommendations prescribe taxation in the residence state, in the case of reverse hybrids by lifting what the investor state perceives to be a corporate veil. To this extent, the recommendation is effectively the same as CFC rules, but more specific and prescriptive than the OECD has ever been on this front.[123] It is not clear why a more aggressive position should be taken with respect to reverse hybrids than with respect to deferral or avoidance through more traditional tax havens. Perhaps this issue of consistency will be addressed in OECD Action 3.[124]

The same could be said of the recommendation that no dividend exemption be given for a payment that is deductible for the payer. Without questioning the appropriateness of such a rule, it is not clear that such a rule is sensible without strong CFC rules. If countries grant a dividend exemption for payments from tax havens (or just low tax countries), it is not clear why they should deny an exemption for payments that are deductible, which can produce the same result.[125] Trying to tax the deductible payment is likely to drive more business to be intermediated through tax havens. The point is that as a tax design matter the denial of a dividend exemption for deductible payments should be integrated and coordinated with CFC rules.

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120 For an example of such a rule, see Harris (2000) s. 27.

121 Again, for the reasons discussed in OECD (2014b) para. 24, the better view is that such a rule does not breach Article 24(4) of tax treaties.

122 Maisto (2014) p. 328 suggests that a 'key element to be addressed in the design of effective CFC legislation is how should states frame such legislation to take account of whether or not the ultimate individual investors are domestic or foreign'.

123 The thrust of the recommendation at paragraph a) in the box at OECD (2014) p. 61 is that if a country has CFC rules it should ensure they cover reverse hybrids and if they don't they should introduce such rules to specifically cover reverse hybrids. Also see at para. 36.

124 Maisto (2014) p. 329 considers coordination of OECD Action 2 and Action 3 'a critical matter'.

125 And see Boidman & Kandev (2014) p. 1237.

Problems of favouring foreign investment are dramatically aggravated where expenses pertaining to foreign source income can be set against domestic source income. This is particularly a problem with financing expenses. It makes little sense to permit residents to set expenses incurred in deriving potentially lowly taxed foreign source income against domestic source income. The result not only encourages source base tax erosion (taxation of income sourced in the residence state), but encourages residents to derive lowly taxed foreign source income (income lowly taxed, expenses deducted against high tax amounts). This may be addressed, but it seems only in part, by OECD Action 4.

As noted above, one way to prevent such distortions is to quarantine foreign expenses so that they can only be deducted in calculating foreign source income. Further, as noted below at 6.4.5, this is an effective measure in addressing some forms of hybrid mismatch arrangements. There are a number of considerations in the form of any such quarantining of a type that are faced when designing a limitation on credit under a foreign tax credit system, e.g. whether the quarantining is worldwide, country-by-country, by type of income or item-by-item (slice-by-slice). These considerations are discussed elsewhere, but there should be consistency between quarantining foreign expenses and the limitation on foreign tax credit (or calculation of exempt foreign income).[126]

Granting a benefit with respect to foreign source income (whether deduction, loss, exemption or credit) should be denied where a similar benefit is granted in another state. Here, some of the OECD recommendations are under prescriptive and others are unnecessarily prescriptive. The rule on no dividend exemption if the dividend is deductible to the payer is under prescriptive; it should apply where anyone else gets a deduction for the dividend, not just the payer. The rules on hybrid payments (DD outcome) and disregarded hybrid payments (D/NI outcome) are unnecessarily prescriptive in that they create complexities that are difficult to administer for little benefit. Many of the worst of these complexities would be addressed by appropriate quarantining (foreign expenses and foreign tax credits) and careful targeting of the use of exemptions for foreign source income.

Irrespective of quarantining, no relief should be given for foreign expenses, losses and taxes if relief is given to any other person anywhere. Clearly, no foreign tax credit should be given for foreign taxes that are credited to someone else. No relief should be granted for a foreign loss (even if quarantined) if relief for the loss is granted to someone else. Concerns that such a rule might work harshly in some cases can be left for tax advisors to plan around, as they often have to do with matters such as limits on interest expense. For this purpose, whether *another* person has been granted relief other than the resident person claiming the benefit is logically determined according to the rules of the residence state.[127]

1.4.5 Effects on the 13 examples and OECD Figures

Mismatches as to payments: Examples 1, 2, 3, 4, 5 and 6

The mismatch in Example 1 (identifying payment) would largely be addressed by quarantining foreign expenses. Country B should not allow this loss on the debt instrument

126 See Harris (2013b) pp. 141-48.

127 So, in the case of a reverse hybrid, the residence state would not consider that a PE loss has been used by a person other than its resident where the host state happens to view the PE as a separate person.

to be deducted against domestic source income if the return on the instrument has a foreign source. Country A should consider amending its law to include debt forgiveness.

The mismatch in Example 2 (recipient of payment) would largely be addressed by comprehensive withholding in Country A. Further, presuming that X is a subsidiary of Y, CFC rules would prevent any avoidance of tax in Country B, whether imposed on Y or directly on Y's shareholders. Alternately, if Y is a subsidiary of Z or X, Country B has little concern in this matter. CFC rules in Country A would then address deferral of residence state tax.

The mismatch in Example 3 (maker of payment) would largely be addressed by quarantining foreign expenses. There are three possibilities here. First, the payment is made through a PE situated in Country B. In this case, quarantining of foreign expenses in Country A would protect its tax base and the deduction in Country B seems appropriate. If Country B permits a loss of the PE to offset profits of say Y, then the deduction in Country A would be denied (irrespective of quarantining). Second, the payment is made through a PE situated in Country A. In this case, comprehensive withholding in Country A will largely address Country A's tax base erosion, and B will get a foreign tax credit for this tax. Country B will be protected by quarantining the foreign interest expense of X and denying it if Z transfers a loss to a related party in Country A.

The third possibility in Example 3 is that there is no PE in Country A or Country B through which the payment is made. If the payment is made through a PE in a third country, then both Country A and Country B will quarantine and potentially deny a deduction for what both believe is a foreign expense, which will resolve any mismatch. It is conceivable that the interest expense is not incurred through a PE anywhere or each of Country A and Country B consider the expense incurred through a PE situated in their jurisdiction. Comprehensive withholding in Country A will largely address Country A's tax base erosion. The risk is in Country B if X is granted a deduction and Y's tax liability is offset with a foreign tax credit granted in respect of Country A withholding tax.[128] Country B could deny a deduction to X in such a case, but perhaps this approach is overly prescriptive and dependent on the treatment in Country A.

A more straightforward rule would be to presume, for the purposes of quarantining expenses but not withholding tax, that a payment made by a resident that is not attributable to a local PE is considered to be a foreign expense and so quarantined. The risk here in this version of Example 3 is that both Country A and Country B quarantine the expense. Tax planners should be able to ensure that such a scenario doesn't arise. The chance that both Country A and Country B simultaneously presume that the expense is attributable to a PE in their own jurisdiction is quite remote and can be left for general anti-abuse rules. Either country may also take the position that the expense has been granted relief to another person and deny the deduction on that basis. Again, the risk of the expense not being deducted anywhere is remote and can be discounted.

The mismatch in Example 4 (quantity of payment) would have to be addressed by Country A changing its domestic law. Country A has let a gain escape its jurisdiction

[128] Some countries may take the view that where they are Country B they will not grant a foreign tax credit for foreign tax on a payment that they consider is made by a resident of Country B. This is a robust position. However, there is at least some risk that as a matter of law the relief from double taxation Article in a tax treaty (Article 23) requires a foreign tax credit be granted.

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

The mismatch in Example 5 (timing of payment) would largely (though not entirely) be resolved by aligning comprehensive withholding of tax from the payment with granting a deduction for it. Tax treaties may be interpreted as limiting the ability of a source state (Country A) to withhold tax at the time of accrual (when the deduction is claimed).[129] However, it might be possible to require the payer to make a pre-payment of tax equal to the withholding at the time of accrual or deny a deduction for payments to non-residents until the payment is made, although the latter option might also be limited by tax treaties.[130] Country B should be aware that in a case like this it might be encouraging its residents to invest offshore. Accordingly, it might consider accelerating the time of recognition of income under this style of deferral instrument. In any case, both Country A and Country B should consider domestic rules to regulate the taxation of deferral instruments and these rules should cater for the foreign elements.

The mismatch in Example 6 (character of payment) would largely be addressed by comprehensive withholding in Country A and denying an exemption in Country B. If Country A does impose withholding tax on the outbound payment and is satisfied that granting a deduction is unlikely to produce a benefit for foreign investors over domestic investors there seems little reason for Country A to care whether Country B taxes or not. Even if it looks through to the investor, it may find an entity that is exempt in Country B for whatever reason. Country A could make a value judgment as to the appropriateness of the exemption or whether Country B really intended it, but the administrative burden of doing so will often be disproportionate for a country in Country A's position. Further, to deny a deduction depending on the tax status of the holder is likely to cause substantial distortions and complications in the administration of Country A tax law.

As a general rule, in the context of Example 6 Country B would deny dividend relief for deductible payments. This applies to all types of dividend relief, whether traditional underlying foreign tax relief given to a parent company or any domestic form of dividend relief extended to foreign dividends. The OECD only focuses on an exemption for foreign dividends and, in the face of substantial source state withholding tax, the benefits of an exemption will not be so great. Further, it is possible for some abuse to occur if an indirect foreign tax credit is granted for a deductible payment.[131] The same is true of other forms of dividend relief, e.g. notional dividend tax credit or lower tax rate for dividends.

Country B may consider the payment in whole or in part as having some other character (than a dividend) that it grants relief for. The most likely example is a return of capital on the investment and the consequence that Y may have to recognise income or gain at some future point, e.g. when the asset is disposed of. Accordingly, this could be viewed as

[129] For example, by suggesting that Article 11(2) limits not only the amount of source state tax but also the time of taxing.
[130] In particular, by Article 24(4).
[131] This is because the credit is likely to be calculated by reference to the corporation tax on the whole of the profits of the payer and not just on the funds used to pay the dividend (which the deduction causes to suffer no corporation tax).

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

Mismatches as to earning activities: Examples 7, 8, 9 and 10

The importance of Examples 7 and 8 in the context of hybrid mismatch arrangements is that they demonstrate a mismatch between countries as to whether there is a taxable presence (PE). This makes the examples similar to those involving hybrid entities, e.g. as in Example 11, which also turns on whether there is a taxable presence or not.

The mismatch in Example 7 (identifying earning activity) would have to be addressed by Country B changing its domestic law. For example, Country B may limit its foreign PE exemption to situations in which the foreign state (Country A) recognises a taxable presence. Country B might also limit the exemption to the amount of the PE's income subject to full tax in Country A. Such requirements are unlikely to breach tax treaties. Subject to tax treaties, Country B might also use the foreign tax credit method or a subject to tax clause.

The mismatch in Example 8 (who contracts) would have to be addressed in domestic law, but tax treaties may override this. Country A might ensure that, as matter of domestic tax law, profits of Y from the sale of goods through a local commissionaire are treated as sourced and taxable in Country A. Tax treaty issues involving commissionaire structures are complicated and are covered by OECD Action 7. Source countries might seek to ensure that their tax treaties are sufficiently broad so that they do not deny a taxing right in this sort of case. The position of Country B is similar to that discussed with respect to Example 7.

The mismatch caused by double dip depreciation through a finance lease in Example 9 (ownership of asset) would largely be addressed by quarantining foreign expenses. As discussed above with respect to Example 3, a quarantining rule may be constructed in such a fashion that it would be difficult for both Country A and Country B to consider that the depreciation expense has a domestic source. Here the focus of the mismatch is on deduction of depreciation in both jurisdictions and not on the character of the payments under the finance lease. However, sale and repurchase agreements can be structured in a way where the primary benefit from disagreement as to ownership of an asset is in mismatch of the character of payments made with respect to the asset.

Figures 2, 3, 19 and 20 of the OECD Draft are examples of mismatches in character of payments caused by disagreement as to who owns an asset as a result of a sale and repurchase agreement. Here one country views a transaction with respect to the asset as a sale and the other views it as a financing transaction (loan). In Figures 2 and 3, the country of the acquirer (Country B) views the transaction as a sale whereas the country of the seller (Country A) sees no transfer of ownership (views it as a financing transaction). In Figure 19 the situations are reversed (as are the country names), the country of the seller (Country B) views the transaction as a sale and the country of the buyer (Country A) views it as no transfer (a financing transaction).

The mismatch in Figure 2 of the OECD Draft would largely be addressed by Country A denying underlying foreign tax relief to B Co for foreign tax that is granted relief in Country B and comprehensive withholding tax in Country A for the deductible financing expenses. In particular, during the term of the repurchase agreement Country A might deny A Co underlying foreign tax relief because B Co is granted dividend relief in

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

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

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

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

The mismatch in Example 10 (character of asset) would largely be addressed by denying a foreign tax credit for foreign tax that has been relieved. There are no considerations for Country A in this case. As noted above at 6.4.4, the broad issue here is that a residence country like Country B perhaps should not grant relief for, in this case, foreign tax that has already been relieved to another person. A detailed consideration of this example is beyond the scope of this paper, but the example demonstrates that care must be taken in designing an indirect foreign tax credit system.[133] Similar issues could arise for Country B if Country A exempts the amount received by X instead of granting dividend tax credits (as in Figure 16 of the OECD Draft, mentioned below).

Figure 1 (and presumably Figure 4) of the OECD Draft involves a mismatch as to the character of an asset that causes a mismatch as to the character of payments in respect of the asset. The consequences are similar to those in Example 6 and the mismatch would

132 This is less likely to be hampered by Article 21 of the UN Model, which preserves greater source state taxing rights over other income when compared with Article 21 of the OECD Model.

133 Broadly, the issue is one of allocating foreign tax to the profits considered distributed; see Harris (2013a) pp. 378-79.

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

Figure 12 of the OECD Draft is presumed to involve a similar example except three countries are involved. As the third country adds nothing to the mismatch feature, the mismatch would still be largely addressed as discussed in Example 6. In this case, it is the added country (Country C) that has the greatest interest in imposing comprehensive withholding tax.

Figure 5 of the OECD Draft involves simultaneous mismatch in identifying assets (and liabilities) and so also in the character of an asset leading to a mismatch in character of payments. Country B views the sale with deferred acquisition price as a sale with debt financing (an additional financial instrument) whereas Country A sees only a sale. This scenario would largely be addressed by comprehensive withholding tax in Country A for the deductible financing expense. Beyond this, the matter is largely a timing issue for Country A. The deduction of the financing expense will mean that B Co has a lower cost base for the asset and so a smaller amount will qualify for depreciation or as a deduction in calculating any gain when B Co subsequently sells the asset. It is not clear why the OECD thinks adjustment should be made in this scenario when no adjustment would be made if Country B simply gave B Co accelerated relief for the price paid, e.g. through early depreciation or a deduction for part of the purchase price.

Figure 16 of the OECD Draft involves the simultaneous mismatch in the character of a financial instrument leading to a mismatch in character of payments as well as a mismatch in allocation of the instrument (who owes the liability). The example adds nothing to the above analysis (particularly that for Examples 6 and 10). The issue would largely be addressed by comprehensive withholding of the outbound payment (by Country B). Further, Country A might deny underlying foreign tax relief for a dividend that was deductible by another person, irrespective of whether that person is the payer. Further, Country A might deny underlying foreign tax relief for foreign tax on the basis that it was relieved to another person (B Co).

Mismatches as to persons: Examples 11, 12 and 13

The mismatch in Example 11 (identifying person) would largely be addressed by comprehensive withholding in Country A. As it sees Z as an entity, it is not clear that Country A has any greater interest in this arrangement. There are likely to be many other scenarios in which a Country A resident is allowed a deduction for a payment to a non-resident that is not subject to substantial taxation, e.g. where the recipient is exempt, in a loss position or resident in a tax haven. It is not clear that this scenario warrants any special treatment. As for Country B, this situation is similar to Examples 7 and 8 in that it may be granting an unnecessary PE exemption and should perhaps limit its exemption to the amount of income of Z subject to tax in Country A. Further, the scenario in Example 11 is unlikely to give rise to tax benefits if Country B adopts a foreign tax credit system. The other comments discussed with respect to Country B for Examples 7 and 8 apply equally to Example 11.

Figure 9 of the OECD Draft is effectively the same as Example 11, but a similar effect may be achieved using a PE instead of a hybrid entity. As discussed above at 6.2.3, a mismatch with a PE may arise under the OECD Model, which under the Authorised OECD Approach under Article 7(2) requires treating the PE in the host state as a separate entity for purposes of calculating its income.[134] While a similar approach is suggested for the residence state in calculating foreign tax relief, the domestic law of many countries will not authorise this, i.e. domestic tax law will ignore dealings between a PE and its owner. This may give rise to a mismatch of the same style as in Example 11 and the comments there are relevant. One difference is that tax treaties may see the payment for purposes of calculating the income of the PE but not for purposes of imposing withholding tax on such a payment. So tax treaties may prohibit withholding tax on the deemed payment.[135]

Figure 10 of the OECD Draft is of a similar nature and does involve a payment by a PE, but now the payment is to a recipient that is part of the same group of companies as the owner of the PE. Here the domestic law of the owner of the PE also disregards the payment by the PE, but this time by reason of a rule disregarding transactions between members of a corporate group. The analysis is similar to that for Example 11. As in that example, as there is an actual payment made by the owner of the PE (through the PE), the host state can impose withholding tax (and should do so) subject to any limits in tax treaties.

Figure 6 of the OECD Draft involves a mismatch as to identification of a person that causes a mismatch as to who owes a liability and so who makes a payment. The consequences are similar to those in Example 3 and the mismatch would largely be addressed as discussed above with respect to that example, e.g. by quarantining of foreign expenses.

Figure 7 of the OECD Draft is similar, but involves a mismatch as to identifying a PE as a separate income tax calculation entity. As discussed above with respect to Figure 9, this mismatch arises under the OECD Model as a result of the Authorised OECD Approach under Article 7(2). Again, the consequences in Figure 7 are similar to those in Example 3 and the mismatch would largely be addressed as discussed above with respect to that example, e.g. by quarantining foreign expenses.

Figure 11 of the OECD Draft involves a mismatch as to identification of a person that causes a mismatch as to who owns an asset (loan) and so who receives a payment. Even though this example involves three countries, the consequences are similar to those in Example 2 and the mismatch would largely be addressed as discussed above with respect to that example, e.g. by comprehensive withholding in the state of the payer and CFC rules in the state of the ultimate investor.

Figure 17 of the OECD Draft similarly involves a mismatch as to the recipient, this time because of the separate identity of the PE, but requires no consideration. This is because this scenario is not beneficial to a taxpayer because the entity characterisation is the opposite to that in Figure 11, i.e. host state sees the PE as recipient and residence state sees the owner (head office) as recipient. This requires no adjustment because the potential for double taxation is precisely what is reconciled under tax treaties and unilateral foreign tax relief. Nevertheless, the OECD Draft contains some less than insightful comments about how and why this example should be excluded from its recommendations.[136]

Figure 18 of the OECD Draft is similar to Figure 17 but the PE is in a third state. If the instrument is a hybrid financial instrument, then the consideration with respect to Example 6 is relevant. If the instrument is not and the reason why the intermediary country does not tax

[134] OECD Commentary on Article 7 para. 15.
[135] OECD Commentary on Article 7 paras 28 & 29.
[136] OECD (2014) paras 255 & 256.

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

Figure 13 of the OECD Draft is similar to Figure 11 but involves the use of two intermediary hybrid companies and two payments. The first payment (Borrower Co to B Co Sub) is the same as in Figure 11 and so the discussion of Example 2 is relevant. The second payment (B Co to A Co) is the same as in Example 11 and Figure 9 and so the discussion of Example 11 is relevant. These mismatches would largely be remedied by comprehensive withholding in the state of the ultimate payer (Country C) and the state of the ultimate investor (Country A) taking greater care in structuring its provision of foreign tax relief.

Figure 14 of the OECD Draft involves a payment between two hybrid entities and so a mismatch both as to the maker of a payment and the recipient of the payment. The example does not add to the above analysis (particularly that for Examples 2 and 3), although it does raise issues as to whether a foreign tax credit will be granted in the recipient state for any withholding tax imposed by the payer state. The example also demonstrates the danger of cascading complexity that can arise if the treatment in either state depends on the treatment in the other state.

Figure 15 of the OECD Draft involves a payment under a hybrid instrument made by a hybrid entity. Again, the example does not add to the above analysis (particularly that for Examples 6 and 11). What this example demonstrates is the danger of the OECD recommendations overlapping and the need for reconciliation rules.

The mismatch in Example 12 (no residence) is not clearly a direct issue for either Country A or Country B. The benefit of the goods has passed into the jurisdiction of Country A and presuming a market value price is paid, there are no immediate tax consequences in Country A for Z. A may deduct the cost of the goods either as trading stock (inventory), a depreciable asset or other capital asset and is unlikely to have any right to withhold tax from the purchase price. If the goods are sold by Y through a PE situated in either Country A or Country B, then the country where the PE is located will tax accordingly. If Y does not sell through such a PE then Country A and Country B have no taxing rights with respect to the sale. The disquiet with this type of example is that Y may avoid paying tax anywhere in the world and as a result have a market advantage in terms of price over other market competitors.

Country A and/or Country B could expand their test of corporate residence (to include both management and formation) or expand their test of PE, but neither is a complete answer to the problems of so called 'toll manufacturing' or 'toll processing'. Any such attempt will simply cause Y to be formed and managed in a more tax friendly environment. If Y is a company controlled by a resident of Country A or Country B then the country of the controller may apply CFC rules to ensure that there is no bias against making a sale through a PE in the jurisdiction of the controller. That is also not a complete answer because corporate groups that suffer CFC rules are at a competitive disadvantage to groups that do not, whatever the market, including the market in the jurisdiction of the controller. There have been a number of recent headline examples involving base erosion and profit shifting which demonstrate that CFC rules should be careful when incorporating an exemption for foreign active business.[137]

The mismatch in Example 13 (dual residence) would largely be addressed by quarantining foreign expenses and denying duplication of losses. This example is similar to the double dip deduction in Example 3 and the discussion with respect to that example is relevant here. The losses of Z are likely to have a foreign source for either Country A or Country B (or both) and so would not be available to offset domestic source income. If, for example, the losses have a source in Country A and are surrendered to a related company there, then Country B would deny a deduction for the losses. Similarly, Country A would deny the losses if they are surrendered under group relief in Country B. The possibility that the loss would be denied in both countries is something that tax planners can usually address and does not seem to warrant specific consideration. Figure 8 of the OECD Draft is effectively the same as Example 13.

Figure 21 of the OECD Draft involves a mismatch as to the character of an entity (not whether it exists or not) that causes a mismatch as to who is allocated the benefit of a payment made by the entity. The host state (Country B) sees B Co as a taxable entity and so recognises that B Co has the benefit of the deduction for interest, which can be surrendered under group relief to B Sub 1. The investor state (Country A) sees a partnership and allocates the interest expense to the partner (A Co). The result is a double deduction for (part of) the same expense. Comprehensive withholding by the state of payer (Country B) will largely address the mismatch in this case. For the investor state, the expense is foreign and might be quarantined for use only against foreign source income, although in this case A Co has plenty of foreign source income. In addition, the investor state perhaps should not give relief for an expense that has been relieved to another person. In this case, as B Co's expense is used by B Sub 1 in the host state (Country B), the investor state (Country A) might deny A Co a deduction for it.

Conclusion

While the OECD Draft contains much to digest and that is worthy of consideration,[138] none of the examples provide compelling reasons that make it *necessary* for the tax treatment in the represented states to be coordinated. The perceived tax benefits in all of the examples, while presented in some complex and sophisticated settings, all boil down to a disagreement as to some basic fundamentals of income tax. In particular, many of the inconsistencies are a result of countries following different approaches as to how to identify income tax fundamentals and, in particular, whether legal form is accepted or more focus is given to substance as when a country relies on classification for financial reporting purposes.

Even if coordination is considered necessary, a country should critically assess whether it will follow the OECD recommendations. The level of complexity and difficulty in administering these rules should not be underestimated, nor should the costs for taxpayers in complying with these rules. For a few sophisticated economies with well funded and highly trained tax administrations, the payoff in shutting down perceived abuses may be considered

137 For example, see Ting (2014).

138 The US has highly complex anti-hybrid rules that have been implemented on a unilateral basis and is considering whether these need amendment in the light of the examples in OECD (2014), see Sheppard (2014).

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

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

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

After identifying whether hybrid mismatch arrangements expose any flaws in the fundamentals of its tax law, a country needs to consider how to respond. The logical and traditional response to flaws in a tax law is making adjustments unilaterally. Another possibility, as recommended by the OECD, involves coordination with other countries. This coordination may be implemented through amendments to domestic law or by conclusion or amendment of tax treaties. A country must be up to the task before concluding tax treaties for fear that it will introduce restrictions on its unilateral ability to respond to flaws and abuses.

In considering the response to hybrid mismatch arrangements, a country must consider what is and what is not capable of administration by its tax authority. It is possible to understand the basic types of benefits sought from hybrid mismatch arrangements in terms of the fundamentals of income taxation and formulate a response accordingly. A more difficult issue is administratively looking through the myriad types and complexities of the arrangements to identify what is going on and then administering the formulated response.

At a fundamental and cynical level, hybrid mismatch arrangements are just a means by which tax planners use two countries with normal (and decent) tax systems to produce mismatches comparable to those achieved by routing investment through a tax haven. Globalisation and the electronic age mean that source states must be cautious in presuming that any foreign country will, as a residence state, tax appropriately a flow of funds that has been let out of the source state with minimal tax. Similarly, a residence state must be cautious in presuming that foreign source income of its residents has suffered sufficient foreign tax such that the income warrants foreign tax relief or any other relief. Neither presumption is warranted simply because the country has a tax treaty with the other country involved. A country's response should be similar and coordinated, irrespective of whether a mismatch is achieved directly as between two countries or indirectly involving a third country.

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