

Mismatches in Tax Outcomes in the Light of BEPS Actions 2 and 5

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At present, the fight against tax evasion, currently often referred to as base erosion and profit shifting (BEPS), has become an important issue not only at the level of the OECD as well as the EU but also for governments around the globe. In this context, hybrid arrangements and existing preferential tax regimes have been identified, inter alia, as key factors for BEPS outcomes. Against this background, the purpose of this article is to critically assess the impact of the measures presented under BEPS Actions 2 and 5 on the existing mismatches thereby focusing on the question whether these proposals are likely to achieve the intended international coherence in corporate income taxation.

Contents

1	Introduction	3
1.1	Existing Disparities between Tax Systems as the Root Cause for Mismatches	3
1.2	Aim and Structure of the Paper	5
2	BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements	7
2.1	Hybrid Mismatches in the Light of the BEPS Project	7
2.1.1	Background and Previous Work with Regard to Hybrid Mismatches	7
2.1.2	Final Report on BEPS Action 2 – Linking Rules to Neutralise Hybrid Mismatches.....	7
2.2	The Linking Rules of the OECD with Regard to D/NI-Schemes.....	9
2.2.1	Introductory Remarks	9
2.2.2	Recommendation 1 – <i>Hybrid Financial Instrument Rule</i>	10
2.2.3	Recommendation 2 – Specific Recommendations for the Tax Treatment of Financial Instruments	17
2.2.4	Recommendation 3 – <i>Disregarded Hybrid Payments Rule</i>	20
2.2.5	Recommendation 4 – <i>Reverse Hybrid Rule</i>	25
2.2.6	Recommendation 5 – Specific Recommendations for the Tax Treatment of Reverse Hybrids	29
2.2.7	Concluding Remarks	32

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- 2.3 Implementation of BEPS Action 2 into Domestic Law 34
 - 2.3.1 General Considerations – BEPS Action 2 in the Light of the Different Economic and Legal Environments..... 34
 - 2.3.2 Implementation of the Linking Rules in the OECD Member States in Asia-Pacific 35
 - 2.3.3 Implementation of the Linking Rules of the OECD in Europe..... 38
 - 2.3.4 Implications of BEPS Action 2 on Singapore 41
 - 2.3.5 Concluding Remarks 45
- 3 BEPS Action 5: Countering Harmful Tax Practices 47
 - 3.1 Preferential Tax Regimes and Their Impact on the Existence of Mismatches in Tax Outcomes..... 47
 - 3.2 Background and Previous Work with regard to Harmful Tax Practices 48
 - 3.3 Final Report on BEPS Action 5: “Nexus Approach” 49
 - 3.3.1 The Substantial Activity Requirement in the Light of BEPS Action 5..... 49
 - 3.3.2 The Substantial Activity Requirement in the Context of IP Regimes..... 51
 - 3.3.3 The Substantial Activity Requirement in the Context of non-IP Regimes 51
 - 3.4 Possible Implications of BEPS Action 5 for Singapore 53
 - 3.4.1 Status Quo: Existing Tax Incentives and Preferential Tax Regimes to Attract Foreign Investors..... 53
 - 3.4.2 Current Tax Incentives in Singapore in the Light of BEPS Action 5: Justified Preferential Tax Regimes or Harmful Tax Practices?..... 53
 - 3.5 Concluding Remarks – The Existing Mismatches in Tax Outcomes in the Light of BEPS Action 5 55
- 4 Conclusion – The Existing Mismatches in Tax Outcomes in the Light of BEPS Actions 2 and 5 56

1 INTRODUCTION

1.1 Existing Disparities between Tax Systems as the Root Cause for Mismatches

Tax policy may be considered one of the core aspects of countries' sovereignty. Given the different aspects that have to be taken into account in this context, countries face different challenges when designing their domestic tax systems. Therefore, bearing in mind that each country has the right to design its tax system in the way it regards most appropriate, the tax systems around the globe differ significantly. In fact, given the numerous disparities of the domestic tax systems throughout the world, mismatches between national income tax legislation are more the rule than the exception.¹ Due to the lack of harmonization with regard to the various tax systems, taxpayers face the opportunity to reduce their overall tax burden by diligently structuring their foreign business relations. As a consequence, cross-border payments may give rise to a deduction in the source state while not being included in the taxable income of the recipient.

In practice, such results are very often achieved by use of hybrid mismatch arrangements. Even though the manifestations of hybrid mismatch arrangements differ significantly, the major point all these structures have in common is that they exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.² In this context, double non-taxation structures causing great concern are arrangements that make use of hybrid financial instruments. While financial instruments are traditionally divided into equity and debt, a wide variety of instruments incorporate elements of both equity and debt and are, thus, referred to as hybrid financial instruments.³ Assuming that these hybrid instruments are treated differently for tax purposes in the respective states of residence of the payer and the payee, most notably as debt in the state of residence of the payer and as equity in the state of residence of the payee, such arrangements lead to double non-taxation.⁴ This is because, due to the mutually incompatible positions regarding the qualification of the financial instrument, the payments based thereon are deductible as interest expenses at the level of the payer while there is no corresponding

¹ See also Cooper, *Some thoughts on the OECD's Recommendations on Hybrid Mismatches*, BIT 2015 Volume 69) Nr 6/7 (Chapter 1).

² Compare Dziurdź, *"Circularly Linked" Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on a Tie-Breaker Test*, BIT 2013, 306 (at 306).

³ See, for example, J.A. Duncan, *General Report*, in *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, International Fiscal Association (IFA) *Cahiers de droit fiscal international* vol. 85a, sec. 3.1. (Kluwer 2000), Online Books IBFD; M. Helminen, *The Dividend Concept in International Tax Law* pp. 251 et seq. (Kluwer 1999) and *Classification of Cross-Border Payments on Hybrid Instruments*, BIT 2004, at 56 et seq., Journals IBFD.

⁴ However, at the same time it is important to note that such mismatches may also result in a double taxation.

inclusion in taxable income at the level of the payee (**Deduction/Non-Inclusion, D/NI**).⁵ At the same time, similar results may be achieved by use of hybrid entities. Due to the deviating qualification of the hybrid entity in the states concerned, a payment may give rise to a deduction while it is not taken into consideration when determining the tax base of the recipient. Since hybrid mismatch arrangements may significantly reduce the overall tax burden for taxpayers, they play an important role in the context of tax planning, thereby opening up a variety of legal possibilities to minimize the tax base.⁶ For example, a deductible payment can give rise to a D/NI outcome where the payment is made by a hybrid entity that is disregarded under the laws of the payee jurisdiction. Furthermore, also deductible payments to a hybrid entity may give rise to a mismatch in tax outcomes, *i.e.* when that payment is not included in ordinary income in the jurisdiction where the payee is established (the establishment jurisdiction) or in the jurisdiction of any investor in that hybrid entity (the investor jurisdiction). Against this background, both the OECD and the European Commission have launched initiatives to counter BEPS resulting from aggressive tax planning, thereby focusing, *inter alia*, on the use of hybrid arrangements.

However, while the international focus is mainly on hybrid mismatches exploiting the differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, it has to be noted that divergent tax outcomes do not necessarily require the use of hybrid financial instruments or entities. Given the disparities with regard to the taxation of foreign income, e.g. the source-based versus residence-based approach, such mismatches may also occur as a result of the interplay of these different concepts. This applies, for example, where the source state grants a deduction of a cross-border interest payment while the residence state of the recipient follows a source-based approach according to which foreign sourced income is, in general, exempt from tax. Furthermore, mismatches may also be the result of the interaction of generally accepted principles, e.g. the deductibility of certain expenses such as interest and royalty payments on the one hand, and preferential tax regimes in the residence state of the recipient on the other hand.

⁵ Compare Lüdicke, "Tax Arbitrage" with Hybrid Entities: Challenges and Responses, BIT 2014, 309 (at 309 et seq.).

⁶ See for an overview of the numerous hybrid arrangements including hybrid financial instruments as well as hybrid instruments, for example, Rosembuj, Intertax 2011, 158 (at 159 ff); Rosembuj, *Abusive Transactions on Financial Hybrids*, Intertax 2011, 234 (at 234 ff); Kofler/Kofler in Brähler/Lösel, FS Djanani (2008) 381 (at 382 ff); Herzig, *Thema I: Hybride Finanzinstrumente im nationalen und internationalen Steuerrecht*, IStR 2000, 482 (at 482 ff); Kaltenberg, *Hybride Finanzierungsinstrumente als Steuerplanungsinstrument – Analyse der steuerlichen Vorteilhaftigkeit am Beispiel von Outbound-Finanzierungsbeziehungen zwischen Deutschland und Luxemburg*, IStR 2012, 837 (at 837 ff); Bünning, *Germany: Use of Partnership and Other Hybrid Instruments in Cross-Border Transactions*, Intertax 2003, 401 (at 401 ff); Joseph, *BEPS, Hybrid Entities and Financing*, Derivatives & Financial Instruments 2015 (Volume 17) Nr 4 (Chapter 1.); Bendlinger, *Hybride Gestaltungen im internationalen Steuerrecht: der Statusbericht der OECD aus österreichischer Sicht*, SWI 2012, 485 (at 485).

In fact, tax competition and the interaction of tax systems can have effects that some countries may view as negative or harmful but others may not. For example, one country may consider investment incentives a policy instrument to stimulate new investment, while another may view such tax incentives as diverting real investment from one country to another. For example, countries with specific structural disadvantages, such as poor geographical location or the lack of natural or personal resources, frequently consider that special tax incentives or tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. This applies, *inter alia*, for Singapore, providing for several tax incentives in order to motivate MNCs to establish their headquarters within its territory. Even though the possible mismatches resulting therefrom, *i.e.* D/NI-outcomes, are identical to the one generated by means of hybrid arrangements, these mismatches may arise in situations where there has been no attempt at tax avoidance. Rather, the reason for these albeit unintended results is simply the lack of harmonization of the different national tax systems and the diverging policy choices made by sovereign legislators. While the issue of hybrid mismatch arrangements is thoroughly dealt with in the course of BEPS Action 2, the impact of preferential domestic tax regimes on the evasion of the tax base is addressed by BEPS Action 5. Under the heading “*Counter harmful tax practices more effectively, taking into account transparency and substance*”, BEPS Action 5 stresses, *inter alia*, the need for “*a holistic approach to evaluate preferential tax regimes in the BEPS context*”.⁷

As the OECD emphasised already in its BEPS Action Plan in 2013, “*there is a need to complement rules to prevent double taxation with a fundamentally new set of standards designed to establish international coherence in corporate income taxation.*”⁸ However, in view of the various policy choices by sovereign tax legislators, it is questionable whether the measures proposed by the OECD are, in fact, likely to lead to the intended international coherence in corporate income taxation.

1.2 Aim and Structure of the Paper

Against this background, the purpose of this article is to critically assess the impact of the measures presented under BEPS Actions 2 and 5 on the existing mismatches, thereby focusing on the question whether these proposals are likely to achieve the intended international coherence in corporate income taxation. Therefore, first, the work of the OECD with regard to the neutralization of hybrid mismatches will be analysed. Since hybrid arrangements have

⁷ See OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, (OECD Publishing), p. 18.

⁸ See OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, p. 15.

been identified as tax planning instruments in order to generate D/NI-outcomes, the authors will give an overview of the previous and current work of the OECD in this respect specifically focusing on the linking rules presented in the Final Report on BEPS Action 2. In this context, special attention will be given to the underlying aim of the approach taken by the OECD. Based thereon, the authors will elaborate on the implementation of the recommendations into domestic law in the light of the existing mismatches. In this context, possible advantages, as well as disadvantages associated with the implementation of the recommended linking rules for the state concerned, shall be identified. Similarly, the linking rules will be assessed from a taxpayer's perspective.

Following up on this, the paper will focus on the work of the OECD on BEPS Action 5. Bearing in mind the possible mismatches in tax outcomes caused by preferential tax regimes provided for only in certain countries, the author will concentrate on the final results of the work of the OECD in this with regard. By doing so, the aim of the respective section 3 is to illustrate the borderline drawn by the OECD between justified preferential tax regimes and harmful tax practices.

Finally, the main findings of the research project will be summarized, thereby providing for some conclusions on the abovementioned issues.

Following this structure, the main purpose of the paper is to deal with the underlying question as to whether the measures developed by the OECD are likely to enhance international coherence in corporate income taxation. In this context, given the different approaches with regard to the BEPS project that may be identified in Asia-Pacific, the paper will focus on the implications of BEPS Actions 2 and 5 in this region. As a consequence, regarding the implementation of BEPS Action 2 in Asia-Pacific, special emphasis will be given to the respective legislative actions in Australia. At the same time, in view of the tax incentives provided for in the Singaporean Income Tax Act, Singapore as a non-member state of the OECD will be taken as a test object in order to assess the impact of BEPS Action 5 on existing preferential tax regimes.

2 BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

2.1 Hybrid Mismatches in the Light of the BEPS Project

2.1.1 Background and Previous Work with Regard to Hybrid Mismatches

Hybrid mismatch arrangements may be considered a well-known phenomenon in international tax law.⁹ In fact, this issue is not new but has been already dealt with in the course of several initiatives within the EU¹⁰ and particularly within the OECD.¹¹ Already in its Report *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, published in 2012 (Hybrids Report 2012), the OECD discussed the implementation of rules specifically addressing hybrid mismatch arrangements. In this context, the OECD concluded that “[d]omestic law rules which link the tax treatment of an entity, instrument or transfer in the country concerned to the tax treatment in another country appear to hold significant potential as a tool to address hybrid mismatch arrangements that are viewed as inappropriate”.¹² Based thereon, the report contained a summary of examples of rules that have been introduced throughout the participating countries to address unintended tax outcomes, such as multiple deductions, deduction/no inclusion, or foreign tax credit generators.¹³ However, these specific recommendations made by the OECD were only partially followed by policy action.

2.1.2 Final Report on BEPS Action 2 – Linking Rules to Neutralise Hybrid Mismatches

Against this background, hybrid mismatch arrangements have also been identified as one of the key issues in the course of the BEPS project of the OECD. In this context, BEPS Action 2, *inter alia*, calls for the development of “recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities.”¹⁴ According to BEPS-Action 2, this may include:¹⁵

- i. [...]

⁹ See Bundgaard, *Cross-Border Tax Arbitrage using Inbound Hybrid Financial Instruments Curbed in Denmark by Unilateral Reclassification of Debt into Equity*, BIT 2008, 33 (33).

¹⁰ For an overview of the different working papers on the level of the European Union compare de Boer/Marres, *BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements*, Intertax 2015, 14 (at 15).

¹¹ See OECD (2011), *Addressing Tax Risks Involving Bank Losses* (2010); OECD, *Corporate Loss Utilisation through Aggressive Tax Planning*, (OECD Publishing); OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, (OECD Publishing).

¹² See OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD Publishing), p. 14, para. 35.

¹³ See OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD Publishing), pp. 15 et seq.

¹⁴ See, OECD (2013), *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing), p. 15.

¹⁵ See, OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, pp. 15 et seq.; compare for an overview also Dourado, *Aggressive Tax Planning in the EU Law in the Light of BEPS: The EC Recommendations on Aggressive Tax Planning and BEPS Actions 2 and 6*, Intertax 2015, 42 (at 51).

- ii. *domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor;*
- iii. *domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);*
- iv. *domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and*
- v. *where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.*

In the light of these outlines provided for in the BEPS Action Plan, and given its practical relevance, the fight against hybrid mismatch arrangements can be considered an essential part of the BEPS project. After having completed the work thereon,¹⁶ the OECD presented its results in the Final Report on BEPS Action 2 published in October 2015.¹⁷ Part I of the Final Report provides recommendations for domestic rules to neutralize the effect of hybrid mismatches where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. On the one hand, the OECD proposes specific changes to the domestic laws of the countries affected by a cross-border hybrid arrangement. According to the considerations of the OECD, these amendments are aimed at ensuring a better alignment between domestic and cross-border tax outcomes.¹⁸ The Report recommends that participating jurisdictions adopt domestic rules targeting two types of payments. Accordingly, the Report is not only concerned with payments under a hybrid mismatch arrangement that result in deduction/non-inclusion outcomes (**Deduction/Non-Inclusion, D/NI**), but also deals with payments that give rise to double deduction outcomes (**Double Deduction, DD**).¹⁹

Furthermore, the Final Report on BEPS-Action 2 proposes the implementation of hybrid mismatch rules that adjust the tax outcomes in one jurisdiction to align them with the tax consequences in another. The thrust of all these hybrid mismatch rules is to link the domestic tax treatment of an entity, instrument or transfer involving a foreign country with the tax treatment in that foreign country. As a consequence, mismatches due to the lack of coordination of

¹⁶ See OECD (2014), *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing); OECD (2014), *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing); OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2014 Deliverable*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing).

¹⁷ See OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing).

¹⁸ See OECD (2015), *Action 2 – 2015 Final Report*, p. 16, para. 4.

¹⁹ See Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 2.1.).

the tax laws in the counties involved shall be eliminated.²⁰ While these rules are targeted at aligning the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction, they shall not disturb the other tax, commercial or regulatory consequences related thereto.²¹ According to the understanding of the OECD, the rules shall apply automatically. In addition, the Report encourages every jurisdiction to introduce all the recommended rules so that the effect of hybrid mismatch arrangement is neutralised even if the counterparty jurisdiction does not have effective hybrid mismatch rules. However, such a comprehensive implementation of the proposed linking rules may, at the same time, lead to an increased risk of double taxation. To counter this potential undesirable effect, the Final Report on BEPS Action 2 recommends the suggested rules to be organized in a strict hierarchy. As a consequence of the rule order proposed by the OECD, only one jurisdiction shall apply rules sufficient to neutralise the mismatch and, since this rule order prevents more than one country applying the rule to the same arrangement, double taxation shall be avoided.²²

The primary rule recommended in the Final Report on BEPS Action 2 is to deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction. Similarly, the deduction shall be denied for payments that give rise to two deductions in respect of the same payment. In the event the primary rule is not applied in the payer jurisdiction, the counterparty jurisdiction can generally apply a defensive rule requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

2.2 The Linking Rules of the OECD with Regard to D/Ni-Schemes

2.2.1 Introductory Remarks

As it regards the neutralization of hybrid mismatches that result in a D/Ni-outcome, the OECD proposes two different approaches. On the one hand, the countries are encouraged to adopt their existing legislation to ensure that their application to cross-border transactions leads to the tax outcomes that are originally intended in a purely domestic situation (so-called "Specific Recommendations"). In this respect, the paper will deal with Recommendation 2 and Recommendation 5 thereby focusing on their relevance with regard to the avoidance of D/Ni-outcomes. On the other hand, the OECD proposes for the implementation of a series of rules specifically targeted at linking the domestic tax treatment of an entity, instrument or

²⁰ See OECD (2015), *Action 2 – 2015 Final Report*, p. 16, para. 6.

²¹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 16, para. 4.

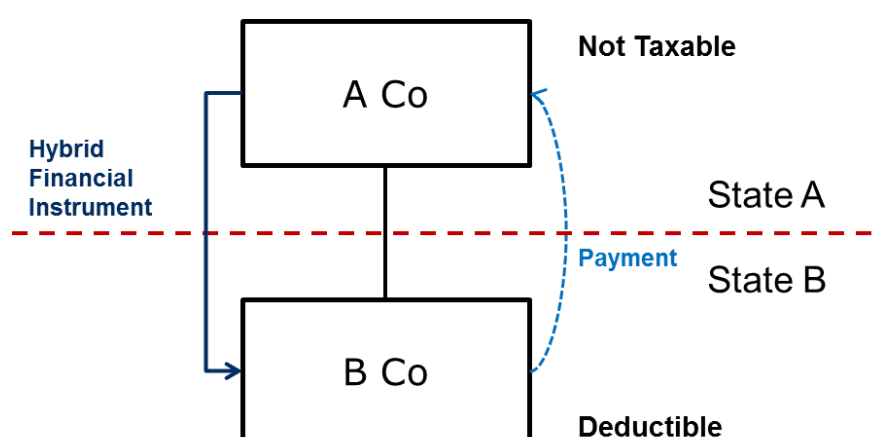
²² See OECD (2015), *Action 2 – 2015 Final Report*, p. 18, para. 15.

transfer involving a foreign country with the tax treatment in that foreign country in order to neutralise the unintended D/Ni-outcomes (so-called “Hybrid Mismatch Rules”). Given their practical relevance in the light of the existing hybrid mismatch arrangements leading to D/Ni-results, the paper will focus on the *Hybrid Financial Instrument Rule* (Recommendation 1), the *Disregarded Hybrid Payments Rule* (Recommendation 3) and the *Reverse Hybrid Rule* (Recommendation 4).

2.2.2 Recommendation 1 – *Hybrid Financial Instrument Rule*

2.2.2.1 Starting Point: D/Ni-Outcome

First, the OECD deals with the D/Ni-outcomes generated by the use of a hybrid financial instrument. Given the wide variety of financial instruments and the different ways they can be characterised and treated for tax purposes, the OECD considers it impossible to comprehensively and accurately identify all the situations where a payment under the instrument can give rise to a hybrid mismatch. Therefore, the *Hybrid Financial Instrument Rule* proposed as Recommendation 1 focuses on whether the payment is expected to give rise to a mismatch in tax outcomes and whether that mismatch is attributable to differences in the way the instrument is taxed under the laws of the payer and payee jurisdictions. The following analysis shall be carried out on the basis of the following simplified illustration of a mismatch arrangement involving the use of a hybrid financial instrument.²³



In this example B Co, resident in State B issues a hybrid financial instrument to A Co, resident in State A. Since the instrument is treated as debt for the purposes of State B law, B Co is entitled to a deduction for interest payments made under the instrument. At the same time, the payment is not subjected to taxation in State A. This mismatch can be due to a number of rea-

²³ The following graphics is based on the work of the OECD (see OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2014 Deliverable*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing), p. 33, para. 52). See also Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.1.).

sons. Most commonly the financial instrument is treated by the issuer as *debt* and by the holder as *equity*. This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief (an exemption, exclusion, indirect tax credit, etc.).

However, the non-taxation at the level of the recipient does not necessarily require a qualification conflict with regard to the underlying financial instrument. Rather, such a mismatch may also arise as a result of the attribution of the payment to a foreign PE of the recipient. If the tax treaty between the residence state of the recipient and the PE state provides for the exemption method, then the payer is entitled to claim a deduction while there is no corresponding taxation in the residence state of the recipient. This also applies when the domestic law of the residence state of the recipient provides for a personal tax exemption for the recipient.

2.2.2.2 Underlying Principle and Legal consequences

Against this background, the OECD proposes for the implementation of a linking rule in order to eliminate the mismatch in tax outcomes.²⁴ The underlying principle of the *Hybrid Financial Instrument Rule* is to link the tax treatment of payments under a financial instrument so that a taxpayer cannot claim a deduction for a financing expense unless that payment is required to be included in ordinary income at the level of the recipient. Therefore, the amount of deductions allowed under the laws of the payer jurisdiction, or the amount of income to be included in the payee jurisdiction shall be adjusted. By doing so, the *Hybrid Financial Instrument Rule* aims at ensuring that the aggregate tax treatment of the arrangement is the same regardless of the form of the instrument used or whether the adjustment is made in the payee or payer jurisdictions.²⁵ However, although the effect of the primary rule is to deny the payer a deduction, in order to bring the tax treatment of the payment in line with the tax treatment in the payee jurisdiction, no changes should be made to the character of the instrument or the payment made under the instrument for tax purposes.²⁶ At the same time, the OECD points out that the adjustment should be no more than is necessary to neutralise the instrument's hy-

²⁴ See OECD (2015), *Action 2 – 2015 Final Report*, p. 25, para. 18.

²⁵ See OECD (2015), *Action 2 – 2015 Final Report*, p. 32, para. 49.

²⁶ See OECD (2015), *Action 2 – 2015 Final Report*, p. 32, para. 50; see also OECD (2015), *Action 2 – 2015 Final Report*, pp. 175 et seq., Example 1.1.

brid effect. Thus, the aim of the *Hybrid Financial Instrument Rule* is to ensure a single taxation of the respective payment while avoiding an unintended double taxation.²⁷

In order to tackle the identified D/Ni-outcomes, the *Hybrid Financial Instrument Rule* follows a two-steps approach: According to the primary rule, the payer jurisdiction shall deny a deduction to the extent the payment gives rise to a D/Ni outcome.²⁸ As a consequence of this primary response, the payer is not entitled to claim a deduction for the payment unless it is treated as ordinary income of the payee. In case the payer jurisdiction does not implement or apply the recommended provision denying the deduction, then the defensive rule calls on the payee jurisdiction to treat the deductible payment as ordinary income under a financial instrument.²⁹ By doing so, the *Hybrid Financial Instrument Rule* is, on the one hand, aimed at ensuring a single taxation of the respective payment in either the source state or the residence state of the recipient. On the other hand, the policy behind the *Hybrid Financial Instrument Rule* is, in general, to prevent a taxpayer from entering into structured arrangements or arrangements with a related party in order to exploit differences in the tax treatment of a financial instrument to produce a D/Ni outcome.³⁰

2.2.2.3 Conditions for the application

2.2.2.3.1 Payment

First, the application of the *Hybrid Financial Instrument Rule* requires a payment. According to the definition provided for in the Final Report on BEPS Action 2,³¹ a payment is any transfer of value and includes an amount that is capable of being paid such as a future or contingent obligation to make a payment.³² In this context, the definition of payment includes the accrual of a future payment obligation even when that accrued amount does not correspond to any increase in the payment obligation during that period. Given the required transfer of value, the definition specifically excludes, however, payments that are only deemed to be made for tax purposes and that do not involve the creation of any new economic rights between the

²⁷ See OECD (2015), *Action 2 – 2015 Final Report*, p. 32, para. 49.

²⁸ See OECD (2015), *Action 2 – 2015 Final Report*, p. 23, Recommendation 1.1.(a): “The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/Ni outcome.”

²⁹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 23, Recommendation 1.1.(b): “If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/Ni outcome.”

³⁰ See OECD (2015), *Action 2 – 2015 Final Report*, p. 25, para. 18.

³¹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 123, Recommendation 12: “Payment includes any amount capable of being paid including (but not limited to) a distribution, credit, debit, accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties. Payment includes any amount capable of being paid including (but not limited to) a distribution, credit, debit, accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties”.

³² See OECD (2015), *Action 2 – 2015 Final Report*, p. 27, para. 28.

parties.³³ Moreover, Recommendation 1 requires the payment to be made on the basis of a certain type of financing arrangement. In this context, the *Hybrid Financial Instrument Rule* encompasses

- i. arrangements that are treated as debt, equity or derivative contracts under local law (“**financial instruments**”),³⁴
- ii. arrangements involving the transfer of financial instruments where differences in the tax treatment of that arrangement result in the same financial instrument being treated as held by more than one taxpayer (“**hybrid transfers**”),³⁵
- iii. arrangements involving the transfer of financial instruments where a payment is made in substitution for the financing or equity return on the transferred asset and differences between the tax treatment of that payment and the underlying return on the instrument have the net-effect of undermining the integrity of the *Hybrid Financial Instrument Rule* (“**substitute payments**”).³⁶

2.2.2.3.2 Hybrid Mismatch – D/NI-Outcome

Furthermore, for the *Hybrid Financial Instrument Rule* to apply the payment must give rise to a D/NI-outcome. According to the OECD, a is subject to a D/NI-outcome to the extent that it is deductible under the laws of the payer jurisdiction while being not included in income under the laws of any jurisdiction where the payment is treated as being received (the payee jurisdiction).³⁷ In this respect, the *Hybrid Financial Instrument Rule* only looks to the expected tax treatment of the arrangement, thereby taking into account the terms of the instrument and the character of the payments made under it, in order to determine whether the payment gives rise to a mismatch. As the OECD points out, the identification of such a hybrid mismatch under a financial instrument is primarily a legal question that requires an analysis of the general rules for determining the character, amount, and timing of payments under a financial instrument in the payer and payee jurisdictions.³⁸

Therefore, first, it has to be assessed whether the payment is, in fact, deductible at the level of the payer. A payment will be treated as “deductible” if, after a proper consideration of the character of the payment and its tax treatment under the laws of the payer jurisdiction, the payer is entitled to take the payment into account as a deduction in calculating its taxable in-

³³ See OECD (2015), *Action 2 – 2015 Final Report*, p. 27, para. 28.

³⁴ See OECD (2015), *Action 2 – 2015 Final Report*, p. 25, para. 19 et seq.

³⁵ See OECD (2015), *Action 2 – 2015 Final Report*, p. 26, para. 23 et seq.

³⁶ See OECD (2015), *Action 2 – 2015 Final Report*, p. 26, para. 25 et seq.

³⁷ See OECD (2015), *Action 2 – 2015 Final Report*, p. 27, para. 29.

³⁸ See OECD (2015), *Action 2 – 2015 Final Report*, p. 40, para. 85.

come. Against this background, deductible payments made under a financial instrument will, for instance, include interest, as well as facilities and lending fees and payments under a derivative contract to the extent they are treated as separate items of deductible expenditure.³⁹

However, a deductible payment only gives rise to a mismatch insofar as it is not included in income under the laws of any jurisdiction where the payment is treated as being received. Thus, the decisive criterion with regard to the payee jurisdiction is the inclusion in ordinary income. Ordinary income refers to those categories of income that are subject to tax at the taxpayer's full marginal rate and that do not benefit from any exemption, exclusion, credit or other tax relief applicable to particular types of payments (such as indirect credits for underlying tax on the income of the payer). A payment will be treated as included in ordinary income to the extent that, after a proper determination of the character and treatment of the payment under the laws of the payee jurisdiction, the payment is required to be incorporated as ordinary income into a calculation of the payee's taxable income. While the inclusion in ordinary income requires the payment to be subject to tax at the payee's full marginal rate, this condition is also fulfilled in case the tax on the inclusion is reduced by a credit or other equivalent tax relief granted by the payee jurisdiction for withholding tax or other taxes imposed by the source jurisdiction on the payment itself.⁴⁰

2.2.2.3.3 Mismatch Must Be Attributable to the Terms of the Instrument

Given a D/Ni-outcome as illustrated above, for the *Hybrid Financial Instrument Rule* to apply, the mismatch in tax treatment must be attributable to the terms of the instrument rather than the status of the taxpayer or the context in which the instrument is held.⁴¹ In other words, the application of Recommendation 1 requires a causal connection between the mismatch in tax outcomes and the terms of the underlying instrument. The Hybrid Mismatch Rules specifies this causal link by means of a negative delimitation. According to Recommendation 1.3, “[a] payment cannot be attributed to the terms of the instrument where the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held.”⁴² As a consequence, the *Hybrid Financial Instrument Rule* does not apply to mismatches that are solely attributable to the circumstances under which an instrument is held.

³⁹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 27, para. 30.

⁴⁰ See OECD (2015), *Action 2 – 2015 Final Report*, p. 28, para. 32.

⁴¹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 41, para. 92.

⁴² See OECD (2015), *Action 2 – 2015 Final Report*, p. 24.

Therefore, if a loan is held through a foreign branch and the mismatch arises solely due to the operation of the branch exemption in the residence country then the mismatch will not be a hybrid mismatch for purposes of the *Hybrid Financial Instrument Rule*.⁴³ The same is true where a taxpayer holds a bond issued by a company through a tax exempt savings account.⁴⁴ In such a case any mismatch in tax outcomes is not attributable to the terms of the instrument but the conditions under which the instrument is held.⁴⁵ Furthermore, the conditions for the application are also not fulfilled with regard to a mismatch in tax treatment that arises in respect of a cross-border payment made to a taxpayer in a **pure territorial tax regime**, *i.e.* a jurisdiction that excludes or exempts all foreign source income. In this scenario, the mismatch in tax outcomes will be attributable to the nature of the payer – more exactly: to the fact that the payer is a non-resident making a payment of foreign source income – rather than the terms of the instrument itself.⁴⁶ Therefore, if a related non-resident payer makes a payment of deductible interest that is treated as foreign source income and the payee jurisdiction does not tax income from foreign sources, the resulting mismatch is not attributable to the terms of the instrument but to the fact that the payee is exempt on all foreign source income. As a consequence, the mismatch is not caught by the *Hybrid Financial Instrument Rule*.⁴⁷ According to the OECD, these cases are to be distinguished from situations where the tax exemption in the residence state of the recipient of the payment is limited to foreign dividend payments. Since in the latter case, the exemption on foreign source income applies only to a particular category of income, the tax exemption is not only depending on the source of the payment but, rather, on the character of the instrument under the laws of the payee jurisdiction and, therefore, the terms of the instrument itself.⁴⁸

2.2.2.3.4 *Personal Scope*

Furthermore, in order to strike a balance between a rule that is clear and comprehensive and that is properly targeted and administrable, the OECD limits the scope of the *Hybrid Financial Instrument Rule* to payments made to “*related persons*” or under a “*structured arrangement*”.⁴⁹ On the one hand, the *Hybrid Financial Instrument Rule* covers payments made to a “*related person*”. According to recommendation 11.1.(a), persons are treated as related for the purposes of the hybrid mismatch rules if they are in the same control group or one person

⁴³ See OECD (2015), *Action 2 – 2015 Final Report*, p. 43, para. 97; see also OECD (2015), *Action 2 – 2015 Final Report*, pp. 197 et seq., Example 1.8.

⁴⁴ See OECD (2015), *Action 2 – 2015 Final Report*, pp. 201 et seq., Example 1.9.

⁴⁵ See OECD (2015), *Action 2 – 2015 Final Report*, p. 43, para. 97.

⁴⁶ See OECD (2015), *Action 2 – 2015 Final Report*, p. 43, para. 98; see also OECD (2015), *Action 2 – 2015 Final Report*, pp. 195 et seq., Example 1.7.

⁴⁷ See OECD (2015), *Action 2 – 2015 Final Report*, p. 43, para. 98.

⁴⁸ See, for example, OECD (2015), *Action 2 – 2015 Final Report*, pp. 175 et seq., Example 1.1.

⁴⁹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 44, para. 99.

holds a 25 % investment in the other or the same person holds a 25 % investment in both.⁵⁰ Two persons are in the same control group if (i) they are consolidated for accounting purposes, (ii) the first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provides that person with effective control over both persons, (iii) the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or (iv) they can be regarded as associated enterprises under Article 9 of the OECD Model Convention.⁵¹ In this context, in determining a person's investment in another person one has to look to the percentage of voting rights or of the value of any equity interests that the first person holds in the second person.⁵²

On the other hand, the *Hybrid Financial Instrument Rule* applies to any person who is a party to a “structured arrangement”. This concept is defined by Recommendation 10. Accordingly, the term structured arrangement covers “any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.”⁵³ The purpose of the structured arrangement definition is to capture those taxpayers who enter into arrangements that have been designed to produce a mismatch in tax outcomes while ensuring taxpayers will not be required to make adjustments under the rule in circumstances where the taxpayer is unaware of the mismatch and derives no benefit from it.⁵⁴ However, even though the concept of a structured arrangement is focused on the deliberate exploitation of hybrid mismatches, the test for whether an arrangement is structured is objective. It applies, therefore, regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes.⁵⁵ This is especially the case if the mismatch has been priced into the terms of the arrangement. Moreover, a structured arrangement may also be given in case the arrangement's design and the surrounding facts and circumstances indicate that the mismatch in tax outcomes was an intended feature of the arrangement. In this context, the OECD test identifies a set of non-exhaustive factors to be taken into consideration when determining whether

⁵⁰ See OECD (2015), *Action 2 – 2015 Final Report*, p. 114, para. 354; see also de Boer/Marres, *Intertax 2015*, 14 (at 18 et. seq.); Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.2.).

⁵¹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 113, Recommendation 11.1.(b); see also Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.2.).

⁵² See OECD (2015), *Action 2 – 2015 Final Report*, p. 114, para. 354.

⁵³ See OECD (2015), *Action 2 – 2015 Final Report*, p. 105, Recommendation 10.1.

⁵⁴ See OECD (2015), *Action 2 – 2015 Final Report*, p. 105 et seq, para. 318.

⁵⁵ See OECD (2015), *Action 2 – 2015 Final Report*, p. 106, para. 319.

an arrangement should be treated as structured.⁵⁶ At the same time, the alternative requirement of a structured arrangement is only fulfilled if the concerned taxpayer is party to the arrangement. A person will be a party to an arrangement when that person has sufficient involvement in the design of the arrangement to understand how it has been structured and what its tax effects might be. Therefore, a person will not be a party to a structured arrangement, if that person does not benefit from, and could not reasonably have been expected to be aware of, the mismatch arising under a structured arrangement.⁵⁷

2.2.2.3.5 Exceptions to the Rule

Finally, the *Hybrid Financial Instrument Rule* provides for an exception. By doing so, Recommendation 1.5 is intended to carve out situations where the tax policy of the deduction under the laws of the payer jurisdiction is to preserve tax neutrality for the payer and payee. As the OECD acknowledges, a jurisdiction may grant an investment vehicle the right to deduct dividend payments in order to preserve its tax neutrality.⁵⁸ Notwithstanding the fact that the payment of a deductible dividend is likely to give rise to a mismatch in tax outcomes, such a payment will, in general, not lead to a hybrid mismatch for the purposes of the *Hybrid Financial Instrument Rule* provided that any resulting mismatch will be attributable to the payer's tax status rather than the ordinary tax treatment of dividends under the laws of that jurisdiction.⁵⁹

2.2.3 Recommendation 2 – Specific Recommendations for the Tax Treatment of Financial Instruments

2.2.3.1 Underlying Aim of Recommendation 2

In addition to the hybrid mismatch rules, the Final Report on BEPS Action 2 contains a series of recommendation specifically targeted on the existing domestic tax systems thereby encouraging the national legislators to adopt their tax systems in order to avoid situations where hybrid mismatches may arise.⁶⁰ Given the disparities between the tax systems around the globe, the OECD acknowledges that the domestic law changes required to implement Recommendation 2 will depend on the current state of a country's domestic law.⁶¹ Rather than simply adjusting the tax treatment of a payment in order to align it with the tax consequences in another jurisdiction, the purpose of these recommendations goes further by seeking to bring the treat-

⁵⁶ See OECD (2015), *Action 2 – 2015 Final Report*, p. 106, para. 319.

⁵⁷ See OECD (2015), *Action 2 – 2015 Final Report*, p. 106, para. 320.

⁵⁸ See OECD (2015), *Action 2 – 2015 Final Report*, p. 44, para. 101.

⁵⁹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 44, para. 101.

⁶⁰ See also de Boer/Marres, *Intertax 2015*, 14 (at 23 et. seq.)

⁶¹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 45, para. 105.

ment of these instruments into line with the tax policy outcomes that will generally apply to the same instruments in the wholly-domestic context.⁶² By doing so, the specific recommendations are aimed at making hybrid mismatches less likely.

2.2.3.2 Denial of dividend exemption for deductible payments

The first specific recommendation presented by the OECD under Recommendation 2 is targeted at domestic tax systems containing a participation exemption for dividend payments. In this context, first, the OECD highlights the underlying purpose and objective of a dividend exemption, *i.e.* to avoid imposing an additional layer of taxation at the shareholder level on income that has already been subject to tax at the entity level.⁶³ Based thereon, Recommendation 2.1 recommends that jurisdictions providing payees with an exemption for dividends, as a mechanism for relieving economic double taxation on corporate profits, shall restrict that exemption to payments that have, in fact, borne tax at the entity level.⁶⁴ If a dividend payment gives rise to a deduction at the level of the distributing company, no such economic double taxation occurs. Consequently, given the underlying aim of the dividend exemption, there is also no reason to exempt the dividend payments in the hands of the receiving shareholder. Therefore, in such situations, the residence state of the recipient shall deny the participation exemption to the extent that the dividend payment is deductible by the payer.⁶⁵ A dividend is deductible for the purposes of Recommendation 2.1, in case the issuer of the instrument under which the payment was made was entitled to a deduction for such payment. In contrast, where a dividend triggers a deduction in another jurisdiction for separate taxpayer due to the existence of a hybrid entity structure or under a hybrid transfer, the payment is not to be regarded as deductible for the purposes of Recommendation 2.1, and does, thus, not generally trigger a denial of the dividend exemption in the payee jurisdiction.⁶⁶

As the OECD points out, the recommendation only affects payments that would otherwise qualify for a dividend exemption or equivalent tax relief. Therefore, other types of non-inclusion, such as a payment that is treated as a return of capital under a share, are not included in the scope of Recommendation 2.1.⁶⁷ With regard to the personal scope, however, the

⁶² See OECD (2015), *Action 2 – 2015 Final Report*, p. 45, para. 104.

⁶³ See OECD (2015), *Action 2 – 2015 Final Report*, p. 46, para. 106.

⁶⁴ See OECD (2015), *Action 2 – 2015 Final Report*, p. 46, para. 106.

⁶⁵ See OECD (2015), *Action 2 – 2015 Final Report*, p. 45, Recommendation 2.1: “In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits.”

⁶⁶ See OECD (2015), *Action 2 – 2015 Final Report*, p. 46 et seq, para. 110.

⁶⁷ See OECD (2015), *Action 2 – 2015 Final Report*, p. 46, para. 109.

OECD does not provide for any limitations. Rather, since the underlying aim is to ensure the original purpose of the domestic dividend exemption, the amendment should apply to all deductible dividend payments regardless of the relationship between the persons involved.⁶⁸

2.2.3.3 Restriction of foreign tax credits under a hybrid transfer

The second domestic law recommendation proposed under Recommendation 2 deals with the issue of the duplication of tax credits under hybrid transfers.⁶⁹ A hybrid transfer exploits differences between two countries in their rules for attributing income from an asset with the effect that the same payment is treated as derived simultaneously by different taxpayers resident in different jurisdictions.⁷⁰ Since there is only one underlying payment, however, the economic benefit of that payment will be shared between the parties under the terms of the hybrid transfer. Against this background, Recommendation 2.2 sets out a rule that aligns the rules for granting of foreign withholding tax relief with the economic benefit of the payment as shared under the terms of the hybrid transfer.⁷¹ Accordingly, countries that grant a tax credit for source taxation should restrict the amount of the credit in proportion to the net taxable income of the relevant taxpayer under the arrangement.⁷² Given the underlying concept of Recommendation 2.2., *i.e.* to adapt the existing domestic legislation in order to ensure the tax treatment intended with regard to purely domestic situations, the OECD suggests no limitations to the scope.⁷³

2.2.3.4 Interaction between Recommendation 2.1 and the *Hybrid Financial Instrument Rule*

Since both the *Hybrid Financial Instrument Rule* as well as the Specific Recommendation 2.1 deal with the same types of hybrid mismatches, it could be questionable which one of these recommendations takes precedence with regard to D/NI-outcomes in connection with financial instruments. According to the concept followed by the OECD, the *Hybrid Financial Instrument Rule* only operates to the extent the arrangement gives rise to a D/NI outcome.⁷⁴ However, such an outcome requires that, after a proper determination of the character and treatment of the payment under the laws of the payer and payee jurisdictions, a mismatch in

⁶⁸ See OECD (2015), *Action 2 – 2015 Final Report*, p. 45, Recommendation 2.3: “There is no limitation as to the scope of these recommendations.”

⁶⁹ See, for example, de Boer/Marres, *Intertax* 2015, 14 (at 23).

⁷⁰ See OECD (2015), *Action 2 – 2015 Final Report*, p. 47, para. 112.

⁷¹ See OECD (2015), *Action 2 – 2015 Final Report*, p. 47, para. 112.

⁷² See OECD (2015), *Action 2 – 2015 Final Report*, p. 45, Recommendation 2.2: “In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement.”; see also de Boer/Marres, *Intertax* 2015, 14 (at 23).

⁷³ See OECD (2015), *Action 2 – 2015 Final Report*, p. 45, Recommendation 2.3: “There is no limitation as to the scope of these recommendations.”

⁷⁴ See already Section 2.2.2.3 above.

tax outcomes has arisen. In this context, it has to be noted that a proper consideration of the character of the payment and its tax treatment in both jurisdictions will take into account rules in the payee jurisdiction designed to limit double taxation relief on dividend payments made out of after-tax profits.⁷⁵

As a consequence, a payment under a hybrid financial instrument will not be treated as giving rise to a D/NI outcome if the mismatch will be neutralised in the counterparty jurisdiction by a specific rule designed to align the tax treatment of the payment with tax policy outcomes applicable to an instrument of that nature. If the payee jurisdiction does not extend its dividend exemption to a payment that is deductible under the laws of the payer jurisdiction, then no mismatch will arise for the purposes of the *Hybrid Financial Instrument Rule*.⁷⁶ Since the Specific Recommendations may obviate the need for the application of hybrid mismatch rules, they are to be implemented and applied primarily. Therefore, in case the state of residence of the recipient denies the participation to the extent that the payment has given rise to a deduction at the level of the distributing company, there is no D/NI-outcome as required under the *Hybrid Financial Instrument Rule*. Consequently, there is no room for an application of the primary response of the *Hybrid Financial Instrument Rule* in the source state.⁷⁷

2.2.4 Recommendation 3 – Disregarded Hybrid Payments Rule

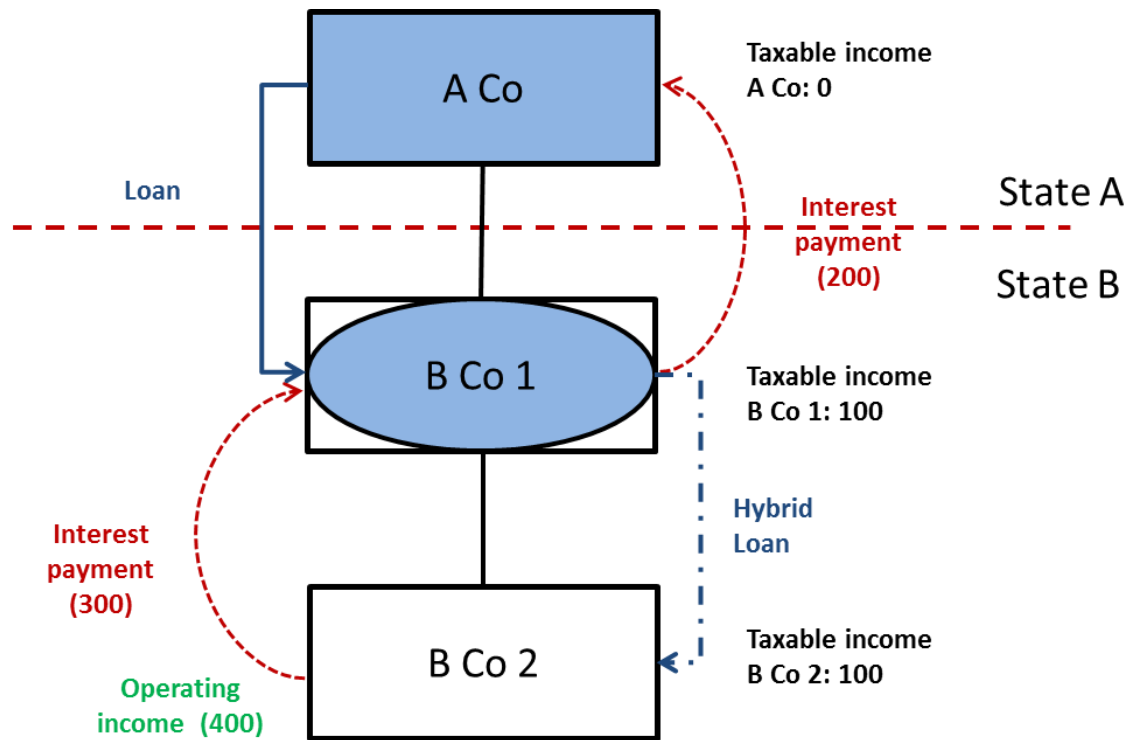
2.2.4.1 Starting Point: D/NI-Outcome

Furthermore, the Final Report on BEPS Action 2 deals with D/NI-outcomes generated in connection with hybrid entities. In this context, the OECD, first, focuses on payments made by a hybrid entity. While the payment gives rise to a deduction at the level of the hybrid entity, it is disregarded, and thus not taxed, in the hands of the receiving taxpayer. Consider the following example:

⁷⁵ See OECD (2015), *Action 2 – 2015 Final Report*, p. 29, para. 35.

⁷⁶ See OECD (2015), *Action 2 – 2015 Final Report*, p. 29, para. 35.

⁷⁷ See also de Boer/Marres, *Intertax* 2015, 14 (at 23).



A Co, resident in State A, establishes the 100 % subsidiary B Co 1, resident in State B, as the holding company for its operating subsidiary B Co 2. B Co 1 is a hybrid entity, *i.e.* an entity that is treated as a separate entity for tax purposes in State B but treated as transparent under the laws of State A. In contrast, B Co 2 is treated as a separate taxable entity in State A and in State B.

B Co 1 borrows money from A Co for the purpose of on-lending that money under a hybrid loan to B Co 2. Due to the diverging tax treatment of the hybrid loan, interest payments on the loan are treated as ordinary income in State B but treated as exempt dividends under the laws of State A. Since State A considers B Co 1 as transparent entity for tax purposes, the interest on the loan between A Co and B Co 1 is disregarded for tax purposes and does not give rise to taxable income in State A. Furthermore, although the payment of interest on the hybrid loan is recognised in State A law, it is treated as an exempt dividend for tax purposes and is, thus, not taken into account in determining A Co's taxable income.

Accordingly, A Co receives no taxable income under this structure. At the same time, B Co 2 generates operating income of 400 while being entitled to a deduction of 300 on the hybrid loan. B Co 1 recognises the interest payment on the hybrid loan but is further entitled to a deduction of 200 on the disregarded interest payment to A Co. As a consequence, in total, the

group for tax purposes in State B recognises 200 of taxable income under this structure on a net return of 400.

2.2.4.2 Underlying Principle and Legal consequences

Against this background, the OECD proposes the implementation of a linking rule that aligns the tax outcomes for the payer and payee.⁷⁸ For this purpose, the *Disregarded Hybrid Payments Rule* provides for a two-steps approach:⁷⁹ The primary recommendation under the *Disregarded Hybrid Payments Rule* is that the payer jurisdiction should deny the deduction that can be claimed for a disregarded payment insofar as the deduction is available to be set-off against an amount that is not treated as income under the laws of the payee jurisdiction (*i.e.* against income that is not “dual inclusion income”).⁸⁰ In the event the payer jurisdiction does not implement or apply the *Disregarded Hybrid Payments Rule*, the payee jurisdiction shall apply a defensive rule requiring the disregarded payment to be included in ordinary income.⁸¹

Although the root cause of the D/NI-outcome is to be seen in the diverging tax treatment of the hybrid payer, the OECD does not intend to solve the underlying qualification conflict. Rather, by way of referring to the tax outcomes related therewith, the *Disregarded Hybrid Payments Rule* is aimed at neutralising the unintended effects of the hybrid mismatch arrangement. However, mere timing and quantification differences should not be treated as giving rise to mismatches in tax outcomes under Recommendation 3. Therefore, excess deductions that are subject to restriction in the payer jurisdiction under the *Disregarded Hybrid Payments Rule* may be carried over to another period, in accordance with the ordinary rules for the treatment of net losses in the respective state, and be applied against dual inclusion income in that period.⁸²

2.2.4.3 Conditions for the application

2.2.4.3.1 Disregarded Payment made by a Hybrid Payer

The application of the *Disregarded Hybrid Payments Rule* requires a disregarded payment, *i.e.* a payment that is deductible under the laws of the payer jurisdiction and is not recognised

⁷⁸ See OECD (2015), *Action 2 – Final Report*, p. 50, para. 119.

⁷⁹ See OECD (2015), *Action 2 – Final Report*, p. 50, para. 119; see also Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.3.).

⁸⁰ See OECD (2015), *Action 2 – Final Report*, p. 49, Recommendation 3.1.(a): “*The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.*”.

⁸¹ See OECD (2015), *Action 2 – Final Report*, p. 49, Recommendation 3.1.(b): “*If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.*”.

⁸² See OECD (2015), *Action 2 – Final Report*, p. 50, para. 118; see also Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.3.).

under the laws of the payee jurisdiction.⁸³ Therefore, first, the deductibility of the payment has to be determined. As the OECD points out, the meaning of deductible and deduction is the same as that used in the other recommendations in the report and generally includes items of current expenditure such as service payments, rents, royalties, interest and other amounts that may be set-off directly against ordinary income while not covering the cost of acquiring a capital asset or an allowance for depreciation or amortization.⁸⁴ Secondly, the payment must be disregarded under the laws of the payee jurisdiction. This is the case if the payment is not treated as a payment under the laws of the payee jurisdiction or that is not otherwise taken into account as a receipt for tax purposes.⁸⁵ Based thereon, the *Disregarded Hybrid Payments Rule* only applies if the non-recognition of the payment in the payee jurisdiction is due to the tax treatment of the hybrid payer.⁸⁶

2.2.4.3.2 D/NI-Outcome – Deduction vs Dual Inclusion Income

Furthermore, for the *Disregarded Hybrid Payments Rule* to apply the payment must result in a hybrid mismatch. According to Recommendation 3.3, a disregarded payment made by a hybrid payer results in a hybrid mismatch if, under the laws of the payer jurisdiction, the deduction may be set-off against income that is not dual inclusion income. As the OECD acknowledges, there are a number of different techniques that a taxpayer can use in the payer jurisdiction to set-off a double deduction against non-dual inclusion income the most common one being the use of a tax consolidation or grouping regime that allows the payer to apply the benefit of a deduction against the income of another entity within the same group.⁸⁷ However, the application of the *Disregarded Hybrid Payments Rule* is not limited to certain techniques used to generate the offset. Rather, if the effect of the structure is to create the opportunity for a deduction under a disregarded payment to be set-off against income that will not be brought into account as ordinary income under the laws of the payee jurisdiction, this will be sufficient to bring the payment within the scope of the *Disregarded Hybrid Payments Rule*.⁸⁸

At the same time, no mismatch will arise to the extent that the deduction in the payer jurisdiction is set-off against income that is included in income under the laws of both the payee and

⁸³ See OECD (2015), *Action 2 – Final Report*, p. 49, Recommendation 3.2.(a).

⁸⁴ See OECD (2015), *Action 2 – Final Report*, p. 51, para. 121.

⁸⁵ See OECD (2015), *Action 2 – Final Report*, p. 53, para. 133.

⁸⁶ See OECD (2015), *Action 2 – Final Report*, p. 49, Recommendation 3.2.(b): “A person will be a hybrid payer where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be a disregarded payment.”

⁸⁷ See OECD (2015), *Action 2 – Final Report*, pp. 293 et seq., Example 3.2.

⁸⁸ See OECD (2015), *Action 2 – Final Report*, p. 54, para. 137.

the payer jurisdiction.⁸⁹ Against this background, the applicability of the *Disregarded Hybrid Payments Rule* decisively depends on the amount of dual inclusion income. According to the concept followed by the OECD, the identification of whether an item should be treated as dual inclusion income requires a comparison of the treatment of the income under the laws of the payer and payee jurisdictions.⁹⁰ In this context, an amount should be treated as dual inclusion income if it is included in income under the laws of both jurisdictions even if there are differences in the way those jurisdictions value that item or in the accounting period in which the income is derived. Furthermore, double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee jurisdiction should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction.⁹¹ As a consequence, also the adjustment under the disregarded hybrid payments rule only operates to the extent that the interest payment exceeds dual inclusion income for the hybrid entity in the payer jurisdiction.⁹²

2.2.4.3.3 *Personal Scope*

Moreover, with regard to the personal scope, the *Disregarded Hybrid Payments Rule* sets forth two alternative requirements. On the one hand, the *Disregarded Hybrid Payments Rule* applies to payments made under a structured arrangement provided that the taxpayer is party to that arrangement. In this respect, Recommendation 3 follows the *Hybrid Financial Instrument Rule*.⁹³ On the other hand, alternatively, the *Disregarded Hybrid Payments Rule* covers payments within the same control group. While the *Hybrid Financial Instrument Rule*, in this context, refers to payments to a related person, the *Disregarded Hybrid Payments Rule* follows the narrower concept of the same control group.⁹⁴ In order to define the concepts of the structured arrangement as well as the same control group, the OECD refers to the general definition provided for under Recommendation 10 and 11.⁹⁵

⁸⁹ See OECD (2015), *Action 2 – Final Report*, p. 54, para. 135.

⁹⁰ See OECD (2015), *Action 2 – Final Report*, p. 51, para. 125.

⁹¹ See OECD (2015), *Action 2 – Final Report*, p. 52, para. 126.

⁹² See OECD (2015), *Action 2 – Final Report*, p. 51, para. 124.

⁹³ See with regard to the personal scope of the *Hybrid Financial Instrument Rule* Section 2.2.2.3.4 above.

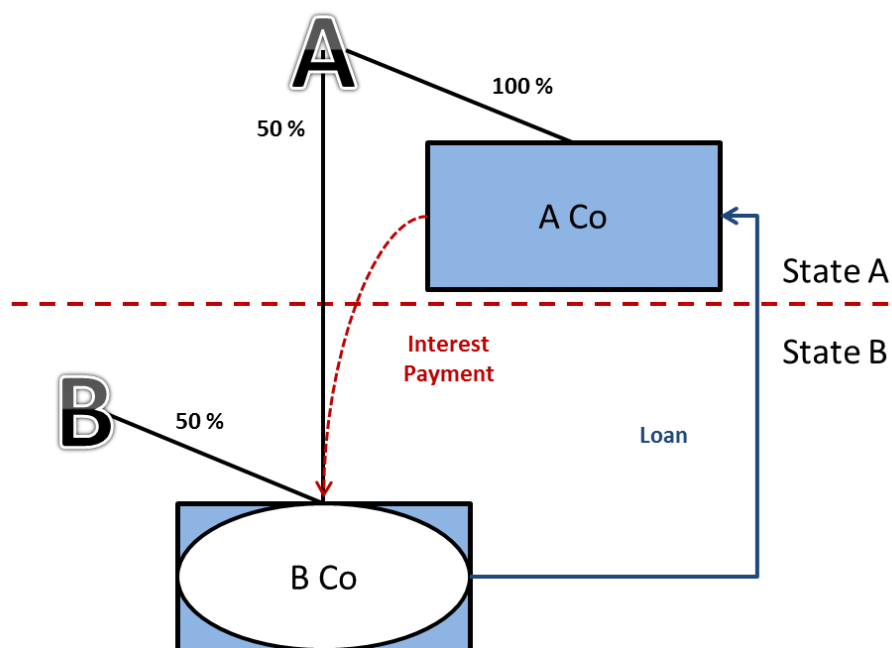
⁹⁴ See OECD (2015), *Action 2 – Final Report*, p. 49, Recommendation 3.4.: “*This rule only applies if the parties to the mismatch are in the same control group*”; see also OECD (2015), *Action 2 – Final Report*, p. 54, para. 138; Kahlenberg, NWB 2015, 490 (at 492).

⁹⁵ See OECD (2015), *Action 2 – Final Report*, p. 54, para. 138.

2.2.5 Recommendation 4 – Reverse Hybrid Rule

2.2.5.1 Starting Point: D/Ni-Outcome

As a further measure to deal with D/Ni-outcomes generated by use of hybrid entities, the OECD proposes a specific linking rule aimed at *Reverse Hybrid* structures. In general, the hybrid mismatches referred to in this context are due to the interplay of three different jurisdictions: the jurisdiction where the hybrid entity is established (establishment jurisdiction), the residence state of the investor (investor jurisdiction) and the source state of the payment (payer jurisdiction). While the hybrid entity is considered as transparent for tax purposes in its establishment jurisdiction, the investor jurisdiction treats the hybrid entity as a separate taxpayer (*Reverse Hybrid*).⁹⁶ The following example illustrates the D/Ni-outcomes resulting from this diverging qualification of the hybrid entity:⁹⁷



In this example, two individuals, one resident in State A (Individual A), the other one resident in State B (Individual B) intend to make a loan to A Co, a company resident in State A and wholly owned by Individual A. Instead of a direct loan, A and B interpose B Co, an entity incorporated in State B that loans money to A Co. Consequently, the interest payment on the loan is deductible at the level of A Co. However, due to the interposition of the hybrid entity

⁹⁶ See with regard to the D/Ni-outcomes resulting from this diverging treatment, for example, Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.4.); Kahlenberg/Kudert, *SWI 2015*, 52 (at 56); Valta, *ISR 2014*, 249 (at 252).

⁹⁷ The following graphics is based on the work of the OECD on BEPS Action 2 (see OECD (2015), *Action 2 – Final Report* pp. 302 et seq., Example 4.2).

B Co, only half of the payment is taxed at the level of the recipient: According to the laws in State B, 50 % of the payments is attributed to Individual A and is exempt from tax as foreign source income of a non-resident. However, since State A treats B Co as a separate entity for tax purposes, no amount of the payment is included in income under Country A law. The other half of the payment is attributed to Individual B and is subject to tax at the full marginal rate applicable to interest income. As a result, half of the payment is deductible in the payer jurisdiction and not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received.⁹⁸

2.2.5.2 Underlying Principle and Legal consequences

In order to tackle the D/Ni-outcome illustrated above, the OECD proposes the implementation of a linking rule that denies a deduction for such payments to the extent they give rise to a D/Ni-outcome.⁹⁹ Given the risk of double taxation, the adjustment should be no more than is necessary to neutralise the hybrid effect that results from interposing the *Reverse Hybrid* between the payer and the investor.¹⁰⁰ Therefore, if part of the payment remains subject to tax in the investor or establishment jurisdiction then that part of the payment should remain deductible.¹⁰¹ In contrast to the other hybrid mismatch rules, the *Reverse Hybrid Rule* does not provide for a secondary (defensive) linking rule.¹⁰² Given the specific recommendations to adopt or enhance CFC or other offshore investment legislation that would require payments to a *Reverse Hybrid* to be included in income in the investor jurisdiction,¹⁰³ according to the OECD, there is no need for a defensive rule.¹⁰⁴ Consequently, the *Reverse Hybrid Rule* is only targeted at the source state of the payment.

2.2.5.3 Conditions for the Application

2.2.5.3.1 Payment to a Reverse Hybrid

The application of the *Reverse Hybrid Rule* requires a payment made to a hybrid entity. In accordance with the *Hybrid Financial Instrument Rule*,¹⁰⁵ the *Reverse Hybrid Rule* encompasses any amount that is capable of being paid including a distribution, credit or accrual.¹⁰⁶

⁹⁸ See OECD (2015), *Action 2 – Final Report*, p. 302 et seq., Example 4.2 (at p. 303, para. 7 et seq.).

⁹⁹ See OECD (2015), *Action 2 – Final Report*, p. 56, para. 144; see also de Boer/Marres, *Intertax 2015*, 14 (at 27); Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Chapter 3.4.).

¹⁰⁰ See OECD (2015), *Action 2 – Final Report*, p. 59, para. 155.

¹⁰¹ See OECD (2015), *Action 2 – Final Report*, p. 302 et seq., Example 4.2 (at p. 303, para. 7 et seq.).

¹⁰² See, for example, *Staats*, *IStR 2014*, 749 (at 753); de Boer/Marres, *Intertax 2015*, 14 (at 27).

¹⁰³ See Section 2.2.6 below.

¹⁰⁴ See OECD (2015), *Action 2 – Final Report*, p. 56, para. 144; see also Janssens/Ledure/Vandepitte/Loos, *ET 2015*, 279 (at 285).

¹⁰⁵ See Section 2.2.2.3.1 above.

¹⁰⁶ According to the OECD, Deductible payments generally include current expenditures such as rents, royalties, interest, payments for services and other payments that may be set-off against ordinary income under the laws of

Furthermore, for the payment to be covered it has to be made to a *Reverse Hybrid*.¹⁰⁷ According to the Final Report on BEPS Action 2, a *Reverse Hybrid* is any person including an unincorporated body of persons such as a trust that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity in the investor jurisdiction.¹⁰⁸ Therefore, the applicability of the *Reverse Hybrid Rule* depends on the qualification of the receiving hybrid entity in the states concerned: On the one hand, the hybrid entity must be treated as transparent¹⁰⁹ for tax purposes in its establishment jurisdiction.¹¹⁰ On the other hand, the hybrid entity must be treated as a separate entity under the laws of the investor jurisdiction.¹¹¹

2.2.5.3.2 D/NI-Outcome

In addition, the application of the *Reverse Hybrid Rule* requires the payment to the *Reverse Hybrid* to give rise to a D/NI-outcome. According to the OECD, such a D/NI-outcome will arise to the extent that the payment is deductible under the laws of the payer jurisdiction and not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received.¹¹² As the OECD points out, when determining whether the payment is subject to a D/NI-outcome, the general rules in the investor jurisdiction are to be applied to the payment that is made to the *Reverse Hybrid* thereby identifying the character, amount and tax treatment of that payment and whether it would have been treated as ordinary income if it had been paid directly to the investor.¹¹³

the payer jurisdiction in the period they are treated as made (see OECD (2015), *Action 2 – Final Report*, p. 56, para. 145).

¹⁰⁷ See OECD (2015), *Action 2 – Final Report*, p. 55, Recommendation 4.2.

¹⁰⁸ See OECD (2015), *Action 2 – Final Report*, p. 59, para. 157.

¹⁰⁹ According to the OECD, a person will be treated as transparent under the laws of the establishment jurisdiction if the laws of that jurisdiction permit or require the person to allocate or attribute ordinary income to an investor and such allocation or attribution has the effect that the payment is not included in the income of any other taxpayer (see OECD (2015), *Action 2 – Final Report*, p. 59, para. 160).

¹¹⁰ The establishment jurisdiction will, in the case of entities that are formed by incorporation or registration, be the jurisdiction where that person is registered or established. For entities that can be formed without formal incorporation or registration requirements (such as partnerships and trusts) the establishment jurisdiction will be the jurisdiction under which the entity has been created and/or where the directors (or equivalent) perform their functions (see OECD (2015), *Action 2 – Final Report*, p. 59, para. 159). See also OECD (2015), *Action 2 – Final Report*, p. 122, Recommendation 12: “Establishment jurisdiction, in relation to any person, means the jurisdiction where that person is incorporated or otherwise established.”; OECD (2015), *Action 2 – Final Report* p. 126, para. 397: „[...] For entities such as companies that are established by formal registration this will be the jurisdiction where the entity is registered. For entities such as partnerships or trusts that may not require formal registration, this will be the jurisdiction under whose laws the entity is created or operates.“).

¹¹¹ According to the OECD, if the allocation or attribution of ordinary income by the intermediary will not have any tax consequences for the investor under the laws of the investor jurisdiction, then the intermediary should be considered opaque under the laws of the investor jurisdiction (see OECD (2015), *Action 2 – Final Report*, p. 60, para. 163).

¹¹² See OECD (2015), *Action 2 – Final Report*, p. 57, para. 147.

¹¹³ See OECD (2015), *Action 2 – Final Report*, p. 60, para. 165.

On the one hand, the deductibility of the payment at the level of the payer has to be assessed. In this context, the deduction in any jurisdiction is sufficient to trigger the application of the *Reverse Hybrid Rule*.¹¹⁴ In case the payment is made by a hybrid entity and is, thus, treated as made from more than one jurisdiction, the deduction of the payment in the other jurisdiction is not relevant to the question of whether the payment gives rise to a D/NI outcome under the laws of the jurisdiction applying the *Reverse Hybrid Rule*. Rather, according to the concept followed by the Final Report on BEPS Action 2, the *Reverse Hybrid Rule* should be applied in both the parent and subsidiary jurisdictions in order to neutralise the effect of the mismatch. Consequently, the application of the *Reverse Hybrid Rule* in one jurisdiction does not impact on its application in the other.¹¹⁵

On the other hand, a deductible payment only leads to a D/NI-outcome covered by the *Reverse Hybrid Rule* if neither the establishment jurisdiction nor the investor jurisdiction includes the payment when calculating the ordinary income. In other words, if the payment is brought into account as ordinary income in at least one jurisdiction – be it due to a CFC legislation or any other offshore investments regime¹¹⁶ – then there will be no mismatch for the rule to apply to.¹¹⁷ Therefore, a payment to a *Reverse Hybrid* will not be treated as giving rise to a D/NI outcome if the mismatch is neutralised by the investor or the establishment jurisdiction adopting a specific rule designed to bring into account items of ordinary income paid to a *Reverse Hybrid*.¹¹⁸ As the OECD points out, in this context the burden is on the taxpayer to establish, to the satisfaction of the tax administration, the extent to which the payment:

- i. Has been fully included under the laws of the investor jurisdiction and is subject to tax at the full rate.
- ii. Has not been treated as reduced or offset by any deduction or other relief other than in respect of expenditure incurred by the investor under the laws of the investor jurisdiction.
- iii. Does not carry an entitlement to any credit or other relief.
- iv. Does not give rise to an imported mismatch.¹¹⁹

¹¹⁴ See OECD (2015), *Action 2 – Final Report*, p. 57, para. 148.

¹¹⁵ See OECD (2015), *Action 2 – Final Report*, p. 57, para. 148.

¹¹⁶ See OECD (2015), *Action 2 – Final Report*, p. 305 et seq., Example 4.3 (at 306, para. 5 et seq.); see also See OECD (2015), *Action 2 – Final Report*, p. 58, para. 151; in detail to the interplay between the Recommendations under BEPS Actions 2 and 3 Kahlenberg, *The Interplay between the OECD Recommendations of Actions 2 and 3 Regarding Hybrid Structures*, Intertax 2016, 316 (at 316 et seq.).

¹¹⁷ See OECD (2015), *Action 2 – Final Report*, p. 57, para. 149.

¹¹⁸ A payment that has been fully attributed to the ultimate parent of the group under a CFC regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the *Reverse Hybrid Rule*.

¹¹⁹ See OECD (2015), *Action 2 – Final Report*, p. 57 et seq., para. 150, 154.

According to the concept of the *Reverse Hybrid Rule*, a payment does, however, only give rise to a relevant mismatch if the payment attributed to the investor would have been included as ordinary income if it had been paid directly to the investor.¹²⁰ In other words, the interposition of the *Reverse Hybrid* must have been necessary to bring about the mismatch in tax outcomes. Therefore, where income is allocated by a *Reverse Hybrid* to a tax exempt entity, the payment would not have been taxable even if it had been made directly to the investor and the *Reverse Hybrid Rule* will not apply to deny the deduction.¹²¹

2.2.5.3.3 Personal Scope

As it regards the personal scope, the *Reverse Hybrid Rule*, on the one hand, encompasses payments within a structured arrangement provided that the respective taxpayer is a party to the structured arrangement.¹²² In this respect, the *Reverse Hybrid Rule* follows the *Hybrid Financial Instrument Rule* as well as the *Disregarded Hybrid Payments Rule*.¹²³ At the same time, the *Reverse Hybrid Rule* also covers situations where the receiving *Reverse Hybrid* and the payer are part of the same control group.¹²⁴ With respect to the second alternative, the *Reverse Hybrid Rule* follows the narrower concept of the *Disregarded Hybrid Payments Rule*, *i.e.* to cover only payments within a control group instead of payments to a related person. Also in this context, the OECD refers to the definition provided for under *Recommendation 10* and *11*.¹²⁵

2.2.6 Recommendation 5 – Specific Recommendations for the Tax Treatment of Reverse Hybrids

2.2.6.1 Underlying Aim of Recommendation 5

In addition to the hybrid mismatch rules proposed in order to tackle D/Ni-outcomes generated by using hybrid entities, the OECD presents some specific recommendations with regard to

¹²⁰ See OECD (2015), *Action 2 – Final Report*, p. 55, Recommendation 4.3: “A payment results in a hybrid mismatch if a mismatch would not have arisen had the accrued income been paid directly to the investor.”

¹²¹ See OECD (2015), *Action 2 – Final Report*, p. 60, para. 166; see also OECD (2015), *Action 2 – Final Report*, pp. 299 et seq., Example 4.1 (at 300, para. 6); OECD (2015), *Action 2 – Final Report*, pp. 307 et seq., Example 4.4 (at 308, para. 10)).

¹²² See OECD (2015), *Action 2 – Final Report*, p. 55, Recommendation 4.4.: “The recommendation only applies [...] if the payment is made under a structured arrangement and the payer is party to that structured arrangement.”; see also OECD (2015), *Action 2 – Final Report*, pp. 299 et seq., Example 4.1 (at 300 et seq., para. 7 et seq.).

¹²³ See with regard to the personal scope of the *Hybrid Financial Instrument Rule* Section 2.2.2.3.4 above and with respect to the *Disregarded Hybrid Payments Rule* Section 2.2.4.3.3 above.

¹²⁴ See OECD (2015), *Action 2 – Final Report*, p. 55, Recommendation 4.4.: “The recommendation only applies where the investor, the reverse hybrid and the payer are members of the same control group [...]”; see also Carman, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 3 (Kapitel 3.4.).

¹²⁵ See OECD (2015), *Action 2 – Final Report*, p. 61, para. 168; see with regard to these concepts already Section 2.2.2.3.4 above.

the tax treatment of transparent entities.¹²⁶ In this context, Recommendation 5 sets out three specific recommendations covering, on the one hand, the tax treatment of payments made to a *Reverse Hybrid* under the laws of the investor and establishment jurisdiction and, on the other hand, recommendations on tax filing and information requirements in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor.¹²⁷ As the OECD explicitly points out, these specific recommendations are not hybrid mismatch rules. Consequently, they do not adjust the tax consequences of a payment because of differences in its tax treatment in another jurisdiction. Rather, Recommendation 5 is targeted at the national tax legislators setting out improvements that jurisdictions could make to their domestic law in order to reduce the frequency of hybrid mismatches. According to the underlying purpose of Recommendation 5, these specific recommendations are aimed at bringing the tax treatment of cross-border payments made to transparent entities into line with the tax policy outcomes that would generally be expected to apply to payments between domestic taxpayers.¹²⁸

2.2.6.2 Improvements to CFC and Other Offshore Investment Regimes

First, the OECD deals with the tax treatment of payments made through a *Reverse Hybrid* structure. According to the Final Report on BEPS Action 2, such payments will not result in D/NI-outcomes if the income is fully taxed under a CFC-regime or a similar anti-deferral rule in the investor jurisdiction requiring the investor to include its allocated share of any payment of ordinary income made to the intermediary on a current basis.¹²⁹ Based thereon, the OECD discusses different possibilities to achieve the intended taxation at the level of the investors. In this context, the Final Report on BEPS Action 2 mentions changes to residency rules, CFC rules, and rules that tax a resident investor on changes in the market value of the investment.¹³⁰

According to the OECD, an offshore investment regime in the investor jurisdiction could isolate the requirement of the tax transparency of the *Reverse Hybrid* thereby ensuring a taxation of the investors on the amount of income allocated to them. As the Final Report on BEPS Action 2 emphasises, treating income allocated by a *Reverse Hybrid* as taxable at the level of the investor would have the effect of neutralising any hybrid mismatch under a payment to a

¹²⁶ See de Boer/Marres, *Intertax* 2015, 14 (at 26 et seq.).

¹²⁷ See OECD (2015), *Action 2 – Final Report*, p. 63, para. 169.

¹²⁸ See OECD (2015), *Action 2 – Final Report*, p. 63, para. 170.

¹²⁹ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 171.

¹³⁰ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 172.

transparent entity.¹³¹ Against this background, Recommendation 5.1 recommends that jurisdictions introduce or extend their offshore investment regimes to require a taxpayer to take into account, for tax purposes, any item of ordinary income allocated to that taxpayer by a *Reverse Hybrid*.¹³² Given these consequences of the adoption of an offshore investment regime, the payer jurisdiction could suspend the application of the *Reverse Hybrid Rule* insofar as payments were allocated to investors in the investor jurisdiction.¹³³

2.2.6.3 Limiting the Tax Transparency for Non-Resident Investors

Furthermore, Recommendation 5 focuses on the underlying principle of the concept of tax transparency and its application to reverse hybrids. As the OECD acknowledges, the treatment of an entity as transparent for tax purposes is an effective way for collective investment vehicles to ensure tax neutrality of outcomes for different investors that are subject to different marginal rates of taxation.¹³⁴ At the same time, the OECD emphasises the underlying assumption of this treatment, *i.e.* that the income allocated to the investor will be taxable in the hands of the investor.¹³⁵ However, in a cross-border context, this is not always the case. Against this backdrop, Recommendation 5.2 stipulates that “[a] reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.”¹³⁶ By doing so, Recommendation 5.2 is intended to prevent a non-resident taking advantage of a person’s tax transparency in order to achieve a mismatch in tax outcomes.¹³⁷

Recommendation 5.2. only applies in circumstances where:

- i. the person is tax transparent under the laws of the establishment jurisdiction,
- ii. the person derives foreign sourced income or income that is not otherwise subject to taxation in the establishment jurisdiction, and
- iii. all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.¹³⁸

¹³¹ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 173.

¹³² See OECD (2015), *Action 2 – Final Report*, p. 63, Recommendation 5.1: “Jurisdictions should introduce, or make changes to, their offshore investment regimes in order to prevent D/NI outcomes from arising in respect of payments to a reverse hybrid.”

¹³³ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 173.

¹³⁴ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 174.

¹³⁵ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 174.

¹³⁶ See OECD (2015), *Action 2 – Final Report*, p. 63, Recommendation 5.2.

¹³⁷ See OECD (2015), *Action 2 – Final Report*, p. 64, para. 174.

¹³⁸ See OECD (2015), *Action 2 – Final Report*, p. 64 et seq., para. 175.

In order to avoid such hybrid mismatches connected with tax transparency rules, Recommendation 5.2 provides that the establishment jurisdiction should treat the *Reverse Hybrid* as if it were a resident taxpayer. By doing so, as the OECD points out, the need to apply the *Reverse Hybrid Rule* to such entities will be eliminated.¹³⁹ Furthermore, the investor jurisdiction could continue to include such payments in income under Recommendation 5.1 but provide a credit for any taxes paid in the establishment jurisdiction on the income that is brought into account under such rules.¹⁴⁰

2.2.6.4 Information Reporting for Intermediaries

Finally, when dealing with the tax treatment of reverse hybrids, the OECD focuses on the reporting and filing requirements for tax transparent entities. In this context, Recommendation 5.3 is intended to encourage jurisdictions to maintain appropriate reporting and filing requirements for such entities that are established within that jurisdiction.¹⁴¹ According to the Final Report on BEPS Action 2, this would involve the maintenance of accurate records of who their investors are, how much of an investment each investor holds in the entity and the amount of income and expenditure allocated to those investors including the categories of income and expenditure as determined under the relevant tax or accounting standard.¹⁴² In order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor, these records should be made available, on request, to both investors and to the tax administration in the establishment jurisdiction.¹⁴³ With regard to the legal basis for the information exchange between tax authorities, the OECD refers to Article 26 of the OECD Model Convention as well as the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, Amended by the 2010 Protocol (Multilateral Convention).¹⁴⁴

2.2.7 Concluding Remarks

Given the various recommendations presented by the OECD with regard to the domestic law in order to neutralise the effects of hybrid mismatch arrangements, it is fair to say that these proposals are likely to address the issue of double non-taxation due to the diverging qualification of hybrid financial instruments and hybrid entities effectively. This is mainly due to the concept followed by the OECD. Accordingly, the Final Report on BEPS Action 2 does not define the covered hybrid financial instruments and hybrid entity structures. Rather, the

¹³⁹ See OECD (2015), *Action 2 – Final Report*, p. 64 et seq., para. 175.

¹⁴⁰ See OECD (2015), *Action 2 – Final Report*, p. 64 et seq., para. 175.

¹⁴¹ See OECD (2015), *Action 2 – Final Report*, p. 65, para. 176.

¹⁴² See OECD (2015), *Action 2 – Final Report*, p. 65, para. 176, para. 179.

¹⁴³ See OECD (2015), *Action 2 – Final Report*, p. 65, para. 176.

¹⁴⁴ See OECD (2015), *Action 2 – Final Report*, p. 65, para. 178.

OECD looks at the unintended outcome for tax purposes connected therewith when determining the scope of the proposed provisions. As a consequence, all the different types of hybrid mismatch arrangements are covered in case they lead to a D/NI- or DD-outcome as defined by the respective recommendation. At the same time, it has to be noted that, according to the concept followed by the Final Report, the application of the linking rules does not require the actual lowering of the tax burden as a consequence of the hybrid mismatch arrangement. Rather, and in contrast to the Deliverable on BEPS Action 2,¹⁴⁵ the final Linking Rules are aimed at eliminating mismatches without requiring the jurisdiction applying the rule to establish that it has “lost” tax revenue under the arrangement. Therefore, while neutralising the effect of hybrid mismatch arrangements will address the risks to a jurisdiction’s tax base, this will not be achieved by capturing additional revenue under the hybrid mismatch rules themselves.

As the OECD points out, the rules are intended to drive taxpayers towards less complicated and more transparent tax structuring that is easier for jurisdictions to address with more orthodox tax policy tools.¹⁴⁶ As a consequence, the hybrid mismatch rules are intended to apply automatically and without regard for whether the arrangement has eroded the tax base of the country applying the rule. The underlying considerations of this approach are, on the one hand, to assure consistency in the application of the rules and their outcomes between jurisdictions and, on the other hand, to avoid the practical and conceptual difficulties in distinguishing between acceptable and unacceptable mismatches or trying to allocate taxing rights based on the extent to which a country’s tax base has been eroded through the hybrid mismatch arrangement.¹⁴⁷ The concept of the OECD requires a consistent and coordinated implementation and application of the proposed linking rules in order to ensure predictability of outcomes for taxpayers and to avoid the risk of double taxation. Bearing in mind, however, the lack of legal obligation to transpose the recommendations of the OECD into domestic law, it remains doubtful whether this goal is, in fact, likely to be achieved. Rather, it is far from certain if and to what extent the member states of the OECD, as well as other states, will enact a domestic provision in accordance with the proposed linking rules. Consequently, there will

¹⁴⁵ See OECD (2014), *Action 2: 2014 Deliverable*, p. 29, para. 41, according to which “[a] hybrid mismatch arrangement is an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.”; see also Joseph, *Derivatives & Financial Instruments 2015* (Volume 17) Nr 4 (Chapter 1.).

¹⁴⁶ See also de Boer/Marres, *Intertax 2015*, 14 (at 18 et. seq.).

¹⁴⁷ See OECD (2015), *Action 2 – 2015 Final Report*, p. 95, para. 278.

be a risk of inconsistency and non-coordination possibly leading to unwanted results such as double taxation.

Notwithstanding the general potential to address effectively the issue of hybrid mismatch arrangements, the linking rules proposed by the OECD are only aimed at neutralising their effects while leaving the underlying qualification conflict of the financial instrument or the entity untouched. In this context, the OECD refers to the lack of political willingness to achieve a harmonised tax treatment of entities, instruments, and transfers in order to eliminate the commonly exploited differences.¹⁴⁸ However, given that the root cause for hybrid mismatches, *i.e.* the qualification conflict is not eliminated by the linking rules, such mismatches in tax outcomes are likely to continue to exist. Consequently, in response to the implementation of the linking rules proposed by the OECD, affected taxpayers are likely to restructure their existing arrangements in an effort to preserve the effects for tax purposes including transactions with low or no tax jurisdictions or transactions where returns are exempt from taxation in the payee jurisdiction on the basis that that jurisdiction operates on a territorial basis of taxation. As a result, and given that the existing differences between national tax laws are not affected by the linking rules, taxpayers face the opportunity to replace their hybrid mismatch arrangements by other structures which may still achieve a D/Ni-outcome while being explicitly outside the operation of the recommendations presented in the Final Report on BEPS Action 2.

2.3 Implementation of BEPS Action 2 into Domestic Law

2.3.1 General Considerations – BEPS Action 2 in the Light of the Different Economic and Legal Environments

Against the background of the various recommendations presented by the OECD with regard to D/Ni-outcomes, the following part will deal with the implementation of these proposals into domestic law. In this context, it has to be noted that the recommendations presented by the OECD face different economic and legal environments around the globe. Given the existing disparities with regard to the tax concepts established by sovereign tax legislators as well as the underlying policy considerations,¹⁴⁹ there is a rather uneven picture of the implementation of the proposed linking rules into domestic law. Therefore, the authors will analyse the different approaches that can be identified with regard to the linking rules of the OECD. On

¹⁴⁸ See already OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 13, para. 30: “One theoretical approach to deal with hybrid mismatch arrangements is the elimination of commonly exploited differences in the tax treatment of entities, instruments and transfers. As it does not seem possible to have a harmonized treatment even for the most commonly exploited differences which would eliminate the possibility for mismatches among different countries, this option is simply mentioned for the sake of completeness.”

¹⁴⁹ See also Section 1.1 above.

the one hand, the authors will focus on the Asia-Pacific region thereby giving special attention to Australia as a member state of the OECD that has already announced to implement the recommendation under BEPS Action 2. On the other hand, the paper will deal with the implementation of the linking rules in Europe. In this context, special attention will be given to the recently concluded Anti-Tax Avoidance Directive as a result of the work undertaken at the level of the EU with regard to BEPS. Finally, and based on the interim findings, the authors will analyse the impact of the recommendations presented by the OECD on non-member states thereby focusing on Singapore that is neither a member state of the OECD nor of the EU.

2.3.2 Implementation of the Linking Rules in the OECD Member States in Asia-Pacific

2.3.2.1 Australia as the Leading Player with Respect to the Implementation of BEPS Action 2

When analysing the implementation of the linking rules proposed by the OECD in Asia-Pacific, it has to be noted that the practical importance of these proposals varies significantly throughout the different jurisdictions. This is due to the fact that the use of hybrid arrangements and their importance for tax planning purposes differ as well. In this context, hybrid mismatch arrangements, at least in the past few years, played an important role with regard to structuring business relations with Australia. Accordingly, Australia also seems to play an important role in the course of the implementation of BEPS measures in the Asia-Pacific region. Given the report of the Board of Taxation (BOT) on the “*Implementation of the OECD Hybrid Mismatch Rules*” released in March 2016, Australia is very likely to implement to a full load of recommendations under BEPS Action 2 and can be, therefore, considered the leading player in this respect.

2.3.2.2 BOT Report 2016: Implementation of Several OECD Recommendations

In its report to the treasurer released in March 2016, the BOT presents, in total, 17 recommendations with regard to the implementation of BEPS Action 2 in Australia. As a starting point, the BOT emphasises the commitment of the Australian Government to eliminate, in partnership with the OECD and through the G20, the tax advantage arising from the use of hybrid instruments and hybrid entities whilst ensuring investment activity is not compromised and that Australia remains an economically competitive place to do business. Based thereon, the report, first, notes that Australia already has comprehensive rules to address a number of the BEPS measures including thin capitalisation rules, CFC rules, transfer pricing, general anti-avoidance rules in Part IVA and the multinational anti-avoidance law extension of Part

IVA.¹⁵⁰ However, while these rules address a significant number of BEPS issues, Australia's current domestic tax law does not generally take account of the tax treatment of financial instruments, arrangements or entities in another jurisdiction, which can give rise to hybrid mismatches and does not, therefore, meet the OECD recommendations to address hybrid mismatches laid down in the Final Report on BEPS Action 2. Against this background, the BOT identifies a need to implement the proposed linking rules in order to tackle hybrid mismatch arrangements effectively.¹⁵¹

In this context, the BOT also addresses the economic and compliance costs connected with the recommended implementation. Given the importance of the economic and compliance costs in implementing the proposed linking rules, the BOT recommends, in principle, implementing the recommendations as set out in the Final Report on BEPS Action 2. In this context, the BOT emphasises that, unless there is a compelling reason to do otherwise, the implementation of hybrid mismatch rules in Australia should align with the recommendations of the OECD to ensure coordination, comprehensiveness and consistency with other jurisdictions.¹⁵² However, at the same time, the transposition should be carried out in a manner which fits within Australia's existing laws thereby minimising ongoing compliance costs and legislative complexity. In order to achieve these aims, the report of the BOT proposes some minor modifications and exclusions to the Final Report on BEPS Action 2, without compromising on the key principles underlying the concept presented by the OECD.

As regards the date of the commencement of the proposed linking rules, the BOT report acknowledges the complexity of the hybrid mismatch rules as developed by the OECD and, thus, supports a sufficient lead time prior to commencement of the rules to allow taxpayers to assess their current arrangements and, where necessary, to unwind or restructure existing arrangements. According to the considerations laid down in the BOT report, taxpayers should also be given the opportunity to review the draft and final legislation before the hybrid mismatch rules commence to allow for consultation and certainty in their application.¹⁵³ In this context, the BOT emphasises that taxpayers should be given a minimum period of six months to restructure their affairs and funding arrangements with the final legislation in place. Based thereon, the BOT recommends that the hybrid mismatch rules should commence in Australia

¹⁵⁰ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 16.

¹⁵¹ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 16 et seq.

¹⁵² See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 24.

¹⁵³ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 21.

for payments made on or after the later of 1 January 2018 or six months after the hybrid mismatch legislation receives Royal Assent.¹⁵⁴

Given the proposed lead time in order to provide taxpayers with sufficient notice of the hybrid mismatch rules to be enacted, the BOT concludes that pre-existing arrangements should not, as a general rule, be grandfathered.¹⁵⁵ However, at the same time, the BOT indicates that there may be certain categories of arrangements that are identified as appropriate for grandfathering thereby mentioning, for example, third party arrangements where there is a significant detriment to investors arising from the application of the hybrid mismatch rules.¹⁵⁶

Against this background, the BOT deals with the different recommendations presented in the Final Report on BEPS Action 2. While the BOT recommends, in general, implementing all the hybrid mismatch rules into domestic law, some recommendations are considered unnecessary. This applies, for instance, to the Specific Recommendation 2.2 presented by the OECD with regard to the duplication of foreign tax credits due to hybrid transfers.¹⁵⁷ According to the BOT, there is no integrity risk to the Australian taxation base if the said recommendation were not implemented.¹⁵⁸ Similarly, according to the BOT, there is no significant integrity concern identified with regard to Recommendation 5.¹⁵⁹ Therefore, and given the existing Australian CFC legislation, the implementation of the CFC aspects laid down in Specific Recommendation 5 is not encouraged. Furthermore, the BOT does not consider it appropriate to adopt recommendations 5.2 and 5.3 at this stage.¹⁶⁰

Furthermore, the BOT deals with the issue whether interest withholding tax should continue to apply to interest payments made to non-residents that are denied a deduction under the hybrid mismatch rules. In this context, while the BOT report points out that interest withholding tax collected on a deduction that is denied as a result of the hybrid mismatch rules will be considered commercially inefficient by Australian borrowers, on balance, the BOT recommends that interest withholding tax should continue to apply to interest payments from hybrid debt financing. As the BOT acknowledges, consequently, some taxpayer groups with hybrid financing will be worse off than if had they used equity financing. However, given the inten-

¹⁵⁴ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 21.

¹⁵⁵ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 22.

¹⁵⁶ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 22.

¹⁵⁷ See Section 2.2.3.3 above.

¹⁵⁸ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 29.

¹⁵⁹ See Section 2.2.6 above.

¹⁶⁰ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 45.

tion of the hybrid mismatch rules to have behavioural effects encouraging taxpayers to replace hybrid financing with non-hybrid financing, the BOT considers the imposition of interest withholding tax on hybrid debt financing arrangements appropriate.¹⁶¹

Finally, the BOT deals with the legislative design of the linking rules to be implemented *de lege ferenda*. In this context, first, the BOT considers that the hybrid mismatch rules should be supported by a stand-alone legislative framework and that the legislation should be drafted as a separate and overarching regime in Australia's tax law.¹⁶² Furthermore, the BOT recommends the legislation to be predominately principles-based setting out the high-level policy and concepts underpinning the hybrid mismatch rules. However, given the legal uncertainty connected with the application of such a principle-based approach, the BOT highlights the need of more precise drafting for particular aspects of the hybrid mismatch rules which require clear boundaries.¹⁶³ Moreover, as it regards the application of the hybrid mismatch rules in relation to other parts of Australia's tax law, the BOT concludes that, as a general rule, the hybrid mismatch rules should apply in priority to other parts of the tax law in order to ensure taxpayers are not required to technically assess whether other integrity rules apply only to then be denied a deduction from the application of the hybrid mismatch rules.¹⁶⁴

2.3.3 Implementation of the Linking Rules of the OECD in Europe

2.3.3.1 Original Concept proposed by the European Commission

Regarding the implementation of BEPS Action 2 in Europe, on the one hand, it has to be noted that some countries have announced the unilateral implementation of local versions of financial instrument hybrid mismatch rules. This is especially true for the United Kingdom. According to the draft hybrid mismatch legislation released on 9 December 2015, the UK is intending to implement the OECD hybrid mismatch recommendations thereby adapting the original proposal through the selective use of existing concepts and definitions laid down in the current UK tax legislation. In this context, the UK has announced that its hybrid mismatch rules will commence for payments made on or after 1 January 2017. At the same time, the draft UK hybrid mismatch legislation does not include any grandfathering or transitional provisions.¹⁶⁵

¹⁶¹ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 37.

¹⁶² See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 53.

¹⁶³ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 53.

¹⁶⁴ See BOT (2016), *Implementation of the OECD Hybrid Mismatch Rules*, p. 54.

¹⁶⁵ See HM Revenue & Customs and HM Treasury (2016), *Finance (No. 2) Bill 2016, Explanatory Notes, Volume 1*, Clause 62 and Schedule 10: Hybrid and other mismatches.

On the other hand, when dealing with the implementation of BEPS Action 2 in Europe, special attention has to be given to the recent developments at the level of the EU. In January 2016, the European Commission released a proposal for a directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (Anti-Tax Avoidance Directive, ATAD).¹⁶⁶ As the European Commission points out, these schemes include situations where taxpayers act against the actual purpose of the law, taking advantage of disparities between national tax systems, in order to reduce their tax bill.¹⁶⁷ Based thereon, the proposal for the ATAD set forth anti-tax avoidance rules in six specific fields, *i.e.* the deductibility of interest, exit taxation, a switch-over clause, a general anti-abuse rule (GAAR), CFC rules, and, finally, a framework to tackle hybrid mismatches.

With regard to the issue of hybrid mismatch arrangements, the ATAD Proposal highlighted that hybrid mismatches, being the consequence of differences in the legal characterisation of payments (financial instruments) or entities when two legal systems interact, may often lead to double deductions or a deduction of the income on one side of the border without its inclusion on the other side. Consequently, taxpayers, especially those engaged in cross-border structures, would often take advantage of such disparities amongst national tax systems and reduce their overall tax liability in the Union. In order to counteract these hybrid mismatch arrangements, the European Commission proposed that the legal characterisation given to a hybrid instrument or entity by the member state where a payment, expense or loss, as the case may be, originates shall be followed by the other member state which is involved in the mismatch. In other words, one of the two jurisdictions in a mismatch should give a legal characterisation to the hybrid instrument or entity and the other jurisdiction should accept it. Consequently, the proposed Article 10 reads as follows:¹⁶⁸

*“Where two Member States give a **different legal characterisation to the same taxpayer (hybrid entity)**, including its permanent establishments in one or more Member State, and this leads to either a situation where a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State or a situation where there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the **legal characterisation given to the hybrid entity by the Member State in which the payment has its source, the expenses are incurred or the losses are suffered shall be followed by the other Member State.**”*

¹⁶⁶ See Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM(2016) 26 final.

¹⁶⁷ See COM(2016) 26 final, p. 3.

¹⁶⁸ See COM(2016) 26 final, p. 21.

*Where two Member States give a **different legal characterisation to the same payment** (hybrid instrument) and this leads to a situation where there is a deduction in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the **legal characterisation given to the hybrid instrument by the Member State in which the payment has its source shall be followed by the other Member State.***

While BEPS Action 2 is aimed at neutralising the effects of hybrid mismatch arrangements,¹⁶⁹ the proposed Art 10 ATAD focused on the root causes of the hybrid mismatches, *i.e.* the different legal characterisation of the entity or payment in the concerned member states. By way of stipulating that the legal characterisation given to the hybrid instrument or entity in the source state of the payment should be followed by the other member state, the European Commission intended to eliminate the underlying qualification conflict.

2.3.3.2 The Anti-Tax Avoidance Directive – Final Version

Based on this proposal released by the European Commission, the Council adopted the ATAD in its meeting on 12 July 2016. However, the final version of the ATAD deviates significantly from the underlying proposal. This applies, *inter alia*, for the provision regarding hybrid mismatches. While the European Commission intended to tackle the qualification conflict itself, the concluded ATAD follows a different approach. According to the concept of the ATAD, in order to neutralise the effects of hybrid mismatch arrangements, “*it is necessary to lay down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome.*”¹⁷⁰ Following these tax policy considerations, also the wording of the provision differs significantly when compared to the original proposal.

The issue of hybrid mismatches is dealt with by Art 9 in conjunction with Art 2 para 9 providing for a specific rule in order to eliminate DD- as well as D/NI outcomes. With regard to the latter, Art 9 para 2 stipulates the following:

“To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.”

By doing so, Art 9 Abs 2 ATDA refers to the definition of hybrid mismatch arrangements laid down in Art 2 para 9 ATAD. Accordingly, the term hybrid mismatch means a situation between a taxpayer in one Member State and an associated enterprise in another member state or a structured arrangement between parties in member states where the DD- or D/NI-outcome is attributable to differences in the legal characterisation of a financial instrument or

¹⁶⁹ See Section 2.2.7 above.

¹⁷⁰ See ATAD, recital 13.

entity. Based thereon, Art 2 para 9 lit a ATAD provides for a definition of the encompassed D/Ni-outcomes thereby covering situations where “*there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ('deduction without inclusion')*.” As follows from Art 9 para 2 ATAD, in order to eliminate such a D/Ni outcome, the state of source is required to “*deny the deduction of such payment*”.

2.3.3.3 Implementation of BEPS Action 2 in the Light of the ATAD

Against this background, member states of both the OECD and the EU, such as Austria and the UK, are confronted with two types of rules to neutralise the effects of hybrid mismatches. Given the legal obligation to transpose the Directive’s provisions into domestic law,¹⁷¹ these countries are on the one hand obliged to follow the concept of the ATAD. On the other hand, according to Art 3 ATAD, the member states enjoy considerable leeway with regard to the implementation. In fact, since the provisions laid down in the ATAD qualify as a “*Minimum level of protection*”, the ATAD “*shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.*” Therefore, the member states are entitled to go beyond the requirements of the ATAD when implementing the provisions of the Anti-BEPS-Directive into domestic law. As a consequence, although the recitals of the ATAD emphasise that “[i]t is essential for the good functioning of the internal market that, as a minimum, Member States implement their commitments under BEPS and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion”,¹⁷² it remains doubtful whether this goal will, in fact, be achieved.

2.3.4 Implications of BEPS Action 2 on Singapore

2.3.4.1 Limited Importance of Hybrid Mismatch Arrangements for Tax Planning Purposes as a Starting Point

At the same time, other countries do not face such arrangements as an issue. This is due to the fact that, for example in Singapore, the tax outcome achieved by these structures may be as well achieved without using a hybrid financial instrument.¹⁷³ Given the various tax exemptions with respect to foreign sourced income laid down in Section 13 of the Singapore Income

¹⁷¹ See Art 288 para. 3 TEUF in conjunction with Art 11 para. 1 ATAD.

¹⁷² See ATAD, recital 2.

¹⁷³ See P. (Paul) Lau, *Taxation of Hybrids: A Singaporean Perspective*, Derivs. & Fin. Instrums. (Volume 17) Nr. 4 (2015) (Chapter 4.).

Tax Act as well as the underlying concept, the taxation of inbound payments deductible at the level of the foreign payer at the level of the payee resident in Singapore may be easily avoided. As an example, this applies if the interest is not physically transferred to Singapore, but is instead received via a foreign bank account, most notably in Hong Kong. If at the same time, the terms and conditions and the process of the signing of the loan lack a sufficient nexus to Singapore, the interest received will not be subject to taxation in Singapore. Given this structure to achieve a *D/NI*-result, in Singapore, hybrid financial instruments and hybrid entities lack a sufficient advantage compared to other less complex structures. Therefore, there is no specific need for the use of hybrid financial instruments. At the same time, the *D/NI*-result is not considered unjustified from a Singaporean perspective. Rather, it is in line with the underlying concept, *i.e.* to exempt foreign sourced income in case of non-remittance. Consequently, since there is minimal tax advantage from entering into such arrangements, there appears to be little incentive for companies to engage in tax planning involving hybrid arrangements to achieve a Singapore tax advantage.

2.3.4.2 Tax Guide of the IRAS with Regard to Hybrid Instruments

Notwithstanding their limited importance for tax planning purposes, the issue of hybrid mismatch arrangements has not been completely ignored by the tax administration. In fact, in the area of hybrid instruments, IRAS has provided some form of guidance through an e-Tax guide titled “*Income Tax Treatment of Hybrid Instruments*” published on its website on 19 May 2014. The purpose of the guide is to provide clarity on the factors used to determine whether a financial instrument is considered to be debt or equity for tax purposes. Putting the issue of cross-border hybrid arrangements aside, as the financial market evolves and non-conventional financial instruments being devised for commercial and regulatory reasons (e.g. the additional tier 1 capital required under the Basel III regulatory frameworks for capital and liquidity), there is a need to ascertain the tax treatment of such an advanced financial instrument for domestic tax purposes.

While the issuers of hybrid instruments are often concerned about the tax deductibility of distributions made on such instruments, at present, there are no specific provisions in the Singapore Income Tax Act stipulating the considerations or factors for determining the nature of a hybrid instrument, *i.e.* whether it is a debt or an equity instrument. However, this very determination is crucial for the question whether the distribution is tax deductible in the hands of the issuer. Against this background, the tax authority has attempted to address the problem posed by hybrid instruments focusing on the different classification of the respective instru-

ment. Indeed, if there is no difference in the way the instrument – and, consequently, the nature of the payment arising from that instrument – is classified for tax purposes in both the payer and payee jurisdiction, there will be no mismatch.

According to the IRAS Tax Guide, in determining the characterisation of a hybrid instrument, the first step is to determine its legal form, which involves an examination of the legal rights and obligations created by the instrument in this respect. In case the legal form of a hybrid instrument is not indicative of or does not reflect the rights and obligations, then the facts and circumstances surrounding the instrument and a combination of factors will be examined. In this context, the factors to be considered include – but are not limited to – the following:

- a. nature of interest acquired,
- b. investor's right to participate in issuer's business,
- c. voting rights conferred by the instrument,
- d. the obligation to repay the principal amount,
- e. payout,
- f. investor's right to enforce payment,
- g. classification by other regulatory authority and
- h. ranking for repayment in the event of liquidation or dissolution.

While these factors are primarily intended for the determination of financial instruments issued by a company resident in Singapore, they are also of relevance with regard to instruments issued by foreign companies. In this context, it is clarified in paragraph 6.3 of the e-Tax guide that in the event of a mismatch between how Singapore and the (foreign) jurisdiction characterises the hybrid instrument, the tax authority will “*evaluate the basis for the different characterisations, taking into consideration the specific facts of the case, before it determines the character of the instrument for Singapore income tax purpose*”. As a consequence, given that this evaluation could lead to a uniform classification of the instrument in both states, the qualification conflict would be eliminated. By doing so, when compared to the linking rules of the OECD, the IRAS follows a different concept, *i.e.* to eliminate the root causes of the hybrid mismatch instead of merely neutralising the unintended effects resulting therefrom. However, at the same time, this approach may very well be reconciled with the underlying concept of BEPS Action 2. In fact, also the OECD proposes for changes to existing domestic provisions in order to avoid the incurrence of hybrid mismatches in the first place.¹⁷⁴ As the OECD points out in the context of Recommendation 2.1, if the dividend exemption is denied

¹⁷⁴ See, for example, with regard to recommendation 2 Section 2.2.3 above.

to the extent that the payment has given rise to a deduction at the level of the distributing company then there is no mismatch and, thus, no need to apply the *Hybrid Financial Instrument Rule*.¹⁷⁵ This logic may also be applied to the approach taken by the IRAS: In the absence of a deviating characterisation of the instrument in the payer and payee jurisdiction, there would be no mismatch in tax outcomes. Consequently, there would be no need to apply hybrid mismatch rules such as the ones proposed by the OECD under BEPS Action 2.

2.3.4.3 BEPS Action 2 in the Light of the Current Singapore Income Tax Act

At current, Singapore does not have any specific anti-avoidance rules targeting the mismatches created by hybrid entities or instruments. Rather, on the one hand, the Singapore Income Tax Act provides for a general anti-avoidance rule (GAAR) laid down in Section 33 of the Singapore Income Tax Act.¹⁷⁶ However, it has rarely been applied. The case *Comptroller of Income Tax v AQQ and another appeal* [2014] SGCA 15 was the first such case, since the enactment of section 33 in its current form in 1988.¹⁷⁷ On the other hand, as can be seen from various provisions, the Singapore Income Tax Act is based on implicit anti-abuse considerations in order to ensure that the tax rules are not being exploited for tax planning purposes. For example, in terms of the deductibility of expenses, the domestic tax rules require a clear nexus between the generation of taxable income and the expenses that are sought to be deducted against it.¹⁷⁸ Furthermore, to minimise tax planning opportunities, there is no carry-forward of foreign tax credits. In addition, the carry-forward of losses and capital allowances

¹⁷⁵ See already Section 2.2.3.4 above.

¹⁷⁶ Section 33 of the Income Tax Act:

Para.1: "Where the Comptroller is satisfied that the purpose or effect of any arrangement is directly or indirectly — (a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person; (b) to relieve any person from any liability to pay tax or to make a return under this Act; or (c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act, the Comptroller may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustments as he considers appropriate, including the computation or recomputation of gains or profits, or the imposition of liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement"

Para. 3: "This section shall not apply to — (a) any arrangement made or entered into before 29th January 1988; or (b) any arrangement carried out for bona fide commercial reasons and had not as one of its main purposes the avoidance or reduction of tax."

¹⁷⁷ The case concerns the restructuring of a group of companies through the incorporation of a new entity, AQQ, and transferring the shares of a number of subsidiary companies to AQQ. The intention of the restructuring is to utilise the imputation credits that the group companies have accumulated under the then-existing imputation system for corporate tax purposes. To finance the restructuring, a fixed rate notes was obtained from a bank. Through a circuitous series of payment arrangements, the principal amount of the notes was repaid to the bank within the same day, and interest payments were generated. AQQ claimed a deduction for such interest expenses against the dividends paid by the subsidiary companies, and in the process, obtained a substantial amount of tax refund. In the absence of any cogent explanation for the complex arrangement (with round tripping of the purchase price of subsidiaries and artificial interposition of external entities when the group has sufficient resources to finance the restructuring), the Court of Appeal ruled that the Comptroller of Income Tax was entitled to invoke section 33 to disregard the whole arrangement.

¹⁷⁸ See, for example, with regards to interest payments Section 14 para. 1 lit a Singapore Income Tax Act (Chapter 134); see also, for example, P. (Paul) Lau, *Derivs. & Fin. Instrum.* (Volume 17) Nr. 4 (2015) (Chapter 4.).

are also subject to the satisfaction of the shareholding test, and the same business test (for carry-forward of capital allowances).

Given this legal background, it is questionable whether hybrid mismatch arrangements would be covered by the existing legislation. In this context, it has to be borne in mind that hybrid mismatch arrangements are, in general, not completely artificial but backed by commercial reasons. Therefore, it seems doubtful whether the GAAR could, in fact, be applied to deal with hybrid mismatches that arose from such arrangements. This is also acknowledged by the OECD stating that the terms of general anti-avoidance rules and the frequent need to show a direct link between the transactions and the avoidance of that particular jurisdiction's tax tend to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements.¹⁷⁹ Thus, while GAARs can be used effectively to deal with hybrid mismatch arrangements that are contrived, in general, they do not provide a comprehensive response to cases of unintended double non-taxation where there are, in fact, economic considerations underlying the hybrid mismatch arrangement.¹⁸⁰

Against this backdrop, specifically targeted rules may thus be necessary to deal with the issue of hybrid mismatches. Given the current Singapore tax system, the implementation of the proposed linking rules, if intended, would require legislative amendments. This can already be seen in the implementation of the primary linking rules. At present, a deduction is allowed so long as the expense is incurred in acquiring income. Therefore, the denial of a deduction at the level of the payer on the basis that the corresponding income has not been taxed in the hands of the payee would require an amendment to the current legislation. Similarly, to ensure the taxation of income pursuant to the defensive linking rule where the income would otherwise not be subject to tax in Singapore would also require enacting specific legislation to that effect. However, as has been indicated above,¹⁸¹ if the qualification conflict with regard to the hybrid instrument is eliminated in accordance with the guideline presented by the IRAS, there is no need for the application of specifically targeted hybrid mismatch rules.

2.3.5 Concluding Remarks

The linking rules presented by the OECD as a result of its work on BEPS Action 2 seem to have significant potential to address the issue of hybrid mismatch arrangements. However, as

¹⁷⁹ See OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD Publishing), p. 13, para. 31.

¹⁸⁰ See OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD Publishing), p. 13, para. 32.

¹⁸¹ See Section 2.3.4.2 above.

can be seen from the analysis above, these recommendations cope with different legal and economic environments around the globe. While in some countries, hybrid mismatch arrangements are extensively used in order to generate mismatches in tax outcomes thereby resulting in governments losing corporate tax revenue, other countries do not face this issue to that same extent. As a consequence, also the need to implement the linking rules proposed by the OECD differs significantly among the jurisdictions including member states of the OECD and the EU as well as countries that are neither a member of the OECD nor the EU.

Regarding the Asia-pacific region, special attention has to be given to Australia. Given the report of the Board of Taxation on the “*Implementation of the OECD Hybrid Mismatch Rules*” released in March 2016, Australia is very likely to implement to a full load of recommendations under BEPS Action 2 and can be, therefore, considered the leading player in this respect. As it regards the implementation of BEPS Action 2 in Europe, while some countries have dealt with the issue of BEPS on a unilateral basis, the work at the level of the European Union has to be highlighted. Based on the proposal released by the European Commission in January 2016, the Council recently concluded the final version of the Anti-Tax Avoidance Directive thereby, *inter alia*, targeting the issue of hybrid mismatch arrangements. Consequently, member states of the EU and the OECD, such as Austria or the UK, are confronted with two different approaches in order to neutralise the effects of hybrid mismatch arrangements. Even though the ATAD is aimed at ensuring a consistent and coherent implementation of BEPS Action 2 within the EU, a closer analysis reveals some doubts with regard thereto. As has been shown, this is especially true because of the considerable leeway with regard to the implementation provided for by the ATAD.

Against this background, given the existing disparities between national tax systems, the implementation of BEPS-Action 2 has to be reconciled with the various legal environments around the globe. While the success of the concept followed by the OECD crucially depends on a coherent and consistent transposition and application of the proposed linking rules, a comparison of the approaches undertaken so far gives rise to doubts as to whether this will, in fact, be the case. On the one hand, this is due to the lack of legal obligation to implement the proposed measures. On the other hand, some countries do not face the use of hybrid mismatch arrangements as a significant issue and are, therefore, unlikely to see the need to implement the corresponding linking rules.

Finally, even supposing the hybrid mismatch rules were implemented consistently, there would remain significant possibilities for taxpayers to restructure their business relations in order to generate similar mismatches in tax outcomes, e.g. by the use of transactions with low or no tax jurisdictions or transactions with jurisdiction following a pure territorial tax regime. Since, in the lack of a hybrid element, these mismatches are not covered by BEPS Action 2, the question arises as to whether other BEPS Actions could be of relevance in this regard. This is especially true for BEPS Action 5, dealing with harmful tax practices. Against this background, the following section will analyse the potential impact of the final results of the work on BEPS Action 5 with respect to the existing mismatches in tax outcomes.

3 BEPS ACTION 5: COUNTERING HARMFUL TAX PRACTICES

3.1 Preferential Tax Regimes and Their Impact on the Existence of Mismatches in Tax Outcomes

From a historical perspective, tax policies have been developed primarily to address domestic economic and social concerns. For example, countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider special tax incentives or tax regimes necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. This applies, *inter alia*, to Singapore. Given its relatively small population as well as the limited natural resources, Singapore is interested in inbound investment. Therefore, tax incentives play an important role in the tax policy considerations underlying the Singapore Income Tax Act. To a certain extent, this may also be true for the tax systems within one country. In this context, peripheral regions often experience difficulties in promoting their development and may, at certain stages in this development, benefit from more attractive tax regimes or tax incentives for certain activities. Therefore, even though differences in tax levels and structures may have implications for other countries, these are essentially political decisions for sovereign tax legislators.

However, while one country may view investment incentives as a policy instrument to stimulate new investment, other countries may view investment incentives as diverting real investment from one country to another. Establishing a preferential tax regime may erode the national tax bases of other countries thereby hampering the application of progressive tax rates and the achievement of redistributive goals in these foreign countries. In particular, investors in tax havens, imposing zero or nominal taxation, who are residents of non-haven countries may be able to utilise in various ways those tax haven jurisdictions to reduce their domestic tax liability. Therefore, the interaction of tax systems may be exploited by the enactment of

special tax provisions which principally erode the tax base of other countries thereby redirecting capital and financial flows and the corresponding revenue from the other jurisdictions.

At the same time, given the diverging tax policy considerations, unintended effects may also occur as a consequence of mismatches between existing tax systems, *i.e.* the inconsistency of implementing such preferential tax regimes. While these cases do not involve a country deliberately exploiting the interaction of tax systems to erode the tax base of another country, such unintentional mismatches may nevertheless be exploited by taxpayers to the detriment of either or both countries.

Consequently, and bearing in mind the different effects of the inconsistent implementation of preferential tax regimes illustrated above, a distinction has to be made between, on the one hand, harmful tax practices targeted at attracting investment or savings originating elsewhere or to facilitate the avoidance of other countries' taxes, and, on the other hand, mismatches between national tax systems reflecting different judgements about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country's sovereignty in fiscal matters.

3.2 Background and Previous Work with regard to Harmful Tax Practices

In this context, already in 1998, the OECD has published its report "*Harmful Tax Competition: An Emerging Global Issue*" dealing with preferential tax regimes and the underlying tax policy concerns as well as their delimitation to harmful tax practices.¹⁸² By doing so, as a first step, the OECD points out the potential negative effects of tax havens or harmful preferential tax regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries. Accordingly, such tax practices have the potential to cause harm by, *inter alia*, distorting financial and, indirectly, real investment flows, undermining the integrity and fairness of tax structures, discouraging compliance by all taxpayers as well as causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption.¹⁸³ While practices having all or most of these negative effects will be doubtlessly considered harmful, in other cases, for example where only some of these effects are present, the degree of harm will range along a spectrum and thus the process of identifying harmful tax practices involves a balancing of factors.

¹⁸² See OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing.

¹⁸³ See OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, p. 16, para. 30.

Based on these considerations, the OECD deals with the delimitation of harmful tax practices and justified preferential tax regimes thereby identifying four key factors and eight other factors to be taken into account. Accordingly, the evaluation whether a preferential regime is potentially harmful should be based on an overall assessment of each of the following factors:¹⁸⁴

- i. No or low effective tax rates
- ii. “Ring-Fencing” of Regimes
- iii. Lack of transparency
- iv. Lack of effective exchange of information

In addition to these key factors, the OECD highlights the following eight other factors that may assist in identifying harmful preferential tax regimes:¹⁸⁵

- a. An artificial definition of the tax base
- b. Failure to adhere to international transfer pricing principles
- c. Foreign source income exempt from residence country tax¹⁸⁶
- d. Negotiable tax rate or tax base¹⁸⁷
- e. Existence of secrecy provisions
- f. Access to a wide network of tax treaties
- g. Regimes which are promoted as tax minimisation vehicles
- h. The regime encourages purely tax-driven operations or arrangements¹⁸⁸

3.3 Final Report on BEPS Action 5: “Nexus Approach”

3.3.1 The Substantial Activity Requirement in the Light of BEPS Action 5

While the 1998 Report was followed by a whole load of other reports,¹⁸⁹ the OECD deals with the distinction between harmful tax practices and justified preferential tax regimes in the

¹⁸⁴ See OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, pp. 26 et seq.

¹⁸⁵ See OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, pp. 30 et seq.

¹⁸⁶ According to the OECD, countries exempting all foreign-source income from tax, *i.e.*, the regime is a territorial system, may be particularly attractive since the exemption reduces the effective income tax rate and encourages the location of activities for tax rather than business purposes (see OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, p. 32, para. 73).

¹⁸⁷ As the OECD points out, a flexibility with regard to the determination of the tax rate or the tax base allows the taxpayer and tax authority of the country sponsoring the regime to either negotiate a “soak-up” tax when the home country allows a foreign tax credit or allows the taxpayer to avoid being subject to the home country’s CFC regime when application of the CFC regime depends upon the host country tax rate (see OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, p. 32, para. 74).

¹⁸⁸ According to the OECD, many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities (see OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, p. 34, para. 79).

¹⁸⁹ See OECD (2001), *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices*, OECD Publishing; OECD (2002a), *The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report*, OECD Publishing; OECD (2002b), *Agreement on Exchange of Information in Tax Matters*, OECD Publishing; OECD (2004a), *Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax*

course of the BEPS project. As the OECD points out, current concerns are primarily about preferential regimes that risk being used for artificial profit shifting and about a lack of transparency in connection with certain rulings. Against this background, already the BEPS Action Plan dealt with the issue of harmful tax practices. Under the heading “*Counter harmful tax practices more effectively, taking into account transparency and substance*”, BEPS Action 5, committed the Forum on Harmful Tax Practices (FHTP) to “[r]evamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.”¹⁹⁰ Furthermore, BEPS Action 5 indicates the importance of “*a holistic approach to evaluate preferential tax regimes in the BEPS context*”. Finally, regarding non-OECD-members, BEPS Action 5 stresses the need to consider revisions or additions to the existing framework.¹⁹¹ Based thereon, the OECD has elaborated on the existing beneficial tax systems thereby focusing, especially, on their impact on BEPS outcomes.¹⁹² As a result of its work, in October 2015, the OECD published the Final Report on BEPS Action 5.¹⁹³

By requiring substantial activity for any preferential regime, BEPS Action 5 contributes to the second pillar of the BEPS project, *i.e.* to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where the value is created. As also the OECD points out,¹⁹⁴ this requirement is, at least to some extent, already contained in the 1998 report, in particular, the eight other factors looking at whether a regime “*encourages purely tax-driven operations or arrangements*”.¹⁹⁵ According to the underlying considerations of the Final Report, bearing in mind the elevated importance of the substantial activity factor under BEPS Action 5, this requirement applies to all preferential regimes within scope, including non-IP regimes.¹⁹⁶

Regimes, OECD Publishing; OECD (2004b), *Harmful Tax Practices: The 2004 Progress Report*, OECD Publishing; OECD (2006), *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries*, OECD Publishing.

¹⁹⁰ See OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, p. 18.

¹⁹¹ See OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, p. 18.

¹⁹² See, for example, OECD (2014), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5: 2014 Deliverable*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (released on 16 Sept 2014).

¹⁹³ OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing).

¹⁹⁴ See OECD (2015), *Action 5 – 2015 Final Report*, p. 23, para. 24.

¹⁹⁵ See with regard thereto already footnote 188.

¹⁹⁶ See OECD (2015), *Action 5 – 2015 Final Report*, p. 23 et seq., para. 25.

3.3.2 The Substantial Activity Requirement in the Context of IP Regimes

Given that current concerns in the area of harmful tax practices may be less about traditional ring-fencing and instead relate to corporate tax rate reductions on particular types of income, such as income from the provision of intangibles, the OECD, first, deals with the substantial activity requirement in the context of IP regimes. In this context, the Final Report on BEPS Action 5 established a “*nexus approach*” which looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving tax benefits. By doing so, the “*nexus approach*” builds on the principle that, because IP regimes are designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefiting from these regimes did, in fact, engage in such activities and did incur actual expenditures on such activities. Accordingly, the proportion of expenditures directly related to development activities is considered to demonstrate real value added by the taxpayer and is, therefore, used as a proxy for how much substantial activity the taxpayer undertook.¹⁹⁷ The “*nexus approach*” applies a proportionate analysis to income, under which the proportion of income that may benefit from an IP regime is the same proportion as that between qualifying expenditures and overall expenditures thereby allowing a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. In accordance with the underlying principle of the “*nexus approach*”, benefits should be granted only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer itself.¹⁹⁸ For the purpose of determining what income may receive tax benefits, the “*nexus approach*” applies the following calculation:¹⁹⁹

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

In case the amount of income receiving benefits under an IP regime does not exceed the amount determined by the “*nexus approach*”, the regime has met the substantial activity requirement.

3.3.3 The Substantial Activity Requirement in the Context of non-IP Regimes

While the “*nexus approach*” was developed in the context of IP regimes allowing a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying re-

¹⁹⁷ See OECD (2015), *Action 5 – 2015 Final Report*, p. 24 et seq., para. 29.

¹⁹⁸ See OECD (2015), *Action 5 – 2015 Final Report*, p. 24 et seq., para. 29.

¹⁹⁹ See OECD (2015), *Action 5 – 2015 Final Report*, p. 25, para. 30.

search and development expenditures that gave rise to the IP income, this principle can also be applied to other preferential regimes. Accordingly, such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.²⁰⁰ The substantial activity requirement underlying the “*nexus approach*” establishes a link between income qualifying for tax benefits and the activities necessary to earn the income thereby focusing on the proportion of expenditures as a proxy for activities. In the case of non-IP regimes, the core activities at issue are, in general, geographically mobile activities such as financial and other service activities. Therefore, these activities may not require anything to link them to income because service activities could be seen as contributing directly to the income that receives benefits.²⁰¹ Against this background, the crucial aspect when applying the “*nexus approach*” boils down to the question as to what constitutes the core activities necessary to earn the income. As the OECD points out, given that this question depends on the type of regime, even where regimes are aimed at a similar type of income there can be a wide variation in the application of different countries’ regimes.²⁰² As a consequence, a more detailed consideration of the relevant core activities would need to be undertaken at the time and in the context of a specific regime being considered. At the same time, however, the Final Report on BEPS Action 5 provides some guidelines with regard to different types preferential regimes including, *inter alia*, headquarter regimes.

In general, headquarters regimes grant preferential tax treatment to taxpayers that provide certain services such as managing, coordinating or controlling business activities for a group as a whole or for group members in a specific geographical area. As the OECD points out, these regimes may raise concerns if they are partly or fully insulated from the domestic markets of the country providing the regime (“ring-fencing”) or in case they provide for an artificial definition of the tax base. While these features could be addressed by the existing factors, these regimes could also raise concerns in respect of substance.²⁰³ Against this backdrop, when applying the “*nexus approach*” to such regimes the core income-generating activities of a headquarter company have to be determined. Taking into consideration the particular type of services income received by the company, these core activities could include taking rele-

²⁰⁰ See OECD (2015), *Action 5 – 2015 Final Report*, p. 37, para. 71.

²⁰¹ See OECD (2015), *Action 5 – 2015 Final Report*, p. 37, para. 72.

²⁰² See OECD (2015), *Action 5 – 2015 Final Report*, p. 37, para. 73.

²⁰³ See OECD (2015), *Action 5 – 2015 Final Report*, p. 37, para. 74.

vant management decisions, incurring expenditures on behalf of group entities, and coordinating group activities.²⁰⁴

3.4 Possible Implications of BEPS Action 5 for Singapore

3.4.1 Status Quo: Existing Tax Incentives and Preferential Tax Regimes to Attract Foreign Investors

Traditionally, Singapore has used tax policy as a tool to achieve economic growth and development. Being a small state with limited natural resources, Singapore needs to operate a tax system that supports its economic and social development and provides sustainable revenue for the country. Besides keeping its tax rates competitive, Singapore uses tax incentives to promote investments in specific industries or activities, with the objective of generating economic spinoffs and delivering long-term economic outcomes.

In Singapore, tax incentives are awarded selectively to a small group of companies for a defined time period. To be eligible for the tax incentive, a company must commit to conducting substantive economic activities in Singapore and add significant value to the economy. Such commitments could be in the form of creating a sizeable number of professional jobs for Singaporeans, incurring considerable business spending in Singapore, and also bringing in new capabilities into Singapore. Companies being awarded incentives are subject to regular checks of their contributions and are expected to be compliant with the Singapore tax rules. In this way, Singapore does not condone the artificial shifting of profits not backed by substance.

3.4.2 Current Tax Incentives in Singapore in the Light of BEPS Action 5: Justified Preferential Tax Regimes or Harmful Tax Practices?

BEPS Action 5 concerns the use of preferential tax regime for base erosion and profit shifting activities. BEPS Action 5 requires substantive activity for any preferential regime, and that taxation is aligned with substance so that profits are being taxed in the location where the value is created. In this respect, there should be a demonstrated link between the core activities performed and the income qualifying for the concessionary tax treatment under the preferential tax regime.

In this context, the OECD acknowledged that the nature of the relevant core activities would differ according to the specific preferential tax regime. In this regard, it has provided some guidance for selected types of preferential regimes. With regard to headquarters regime,

²⁰⁴ See OECD (2015), *Action 5 – 2015 Final Report*, p. 37 et seq., para. 75.

OECD's view is that headquarters regime could raise concerns about ring-fencing and could provide an opportunity for diversion of profits through manipulating of the cost based on which the headquarter charges its related companies for management and coordination activities. To demonstrate substance, and a sufficient link between the income and the core activities performed, a headquarter company need to be able to show that it made relevant strategic management decisions and performed significant coordinating activities for the group entities, including incurring expenditures on behalf of the group entities in the jurisdiction where its income is subject to tax. To improve transparency, OECD has proposed to put in place a system of exchange of information in respect of rulings relating to preferential tax regimes.

Against this background, the question arises whether the tax incentive currently provided for by the Singapore Income Tax Act are in line with the substantial activity requirement. Therefore, this section focuses on the headquarter regime laid down in Section 43E Singapore Income Tax Act²⁰⁵ and its compliance with the "nexus approach" established in the course of the work on BEPS Action 5.

Singapore's use of tax incentives is, in principle, aligned with the concept that profits should be taxed where substantive economic activities generating the profits are performed and where the value is created. Moreover, the tax rules governing the incentive awards are transparent. Rules applicable to an incentive regime are clearly legislated in the Singapore Income Tax Act or the Economic Expansion Incentives (Relief from Income Tax) Act, and the relevant Regulations.

The headquarters regime was introduced in Singapore with an objective of attracting foreign companies to set up their regional headquarters in Singapore to provide administrative, management and treasury services to its subsidiaries and associated companies in the region. This, in turn, generates economic spinoffs and creates new business activities for Singapore. To enjoy the tax benefits, the approved headquarter company must have carried out substantive global headquarters activities in Singapore, incurred heavy business spending levels and created employment at the technical, specialist and managerial level for local personnel. In this regard, the preferential tax treatment is only granted to the headquarter company if it is able to

²⁰⁵ As part of the regular review of tax incentive and to simplify the Singapore tax regime, the approved headquarters incentive has been withdrawn. Instead, subject to the meeting of conditions, companies performing qualifying headquarter services may qualify for the existing Development Expansion Incentive – Headquarter Programme with effect from 1 October 2015. Notwithstanding the rationalizing, there is no change in the principle of granting tax incentives.

demonstrate the performance of its core activities in Singapore. The concessionary tax rate to be applied is clearly legislation under Section 43E Singapore Income Tax Act, and the list of qualifying services/activities can be found in the Income Tax (Concessionary Rate of Tax for Approved Headquarters Companies) Regulations. It includes, *inter alia*, business planning and coordination, corporate finance advisory services; credit administration and control, and also research and development work carried out in Singapore. In this sense, the Singapore tax incentive regime for headquarters is unlikely to be very much impacted by BEPS Action 5.

3.5 Concluding Remarks – The Existing Mismatches in Tax Outcomes in the Light of BEPS Action 5

Against this background, the question arises whether the modified “nexus approach” developed in the course of the work on BEPS Action 5 will have some impact on the unintended mismatches connected with preferential tax regimes that have been identified above.²⁰⁶ According to the modified “*nexus approach*”, preferential tax regimes are only considered harmful and are thus covered by BEPS Action 5, if they fail to comply with the substantial activity requirement. In other words, provided that there is a sufficient level of activity required under the preferential tax regime in order to receive the tax benefits, such a regime does not fall under the scope of harmful tax practices encountered by BEPS Action 5. As has been shown above, preferential tax regimes are often based on the tax policy consideration to attract foreign investors.²⁰⁷ These considerations differ between countries: While countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, frequently consider special tax incentives or tax regimes crucial for their economy to grow, other countries do not face the need to offset such non-tax disadvantages. As a consequence, the inconsistency of implementing such preferential tax regimes may lead to mismatches in tax outcomes. However, since these preferential tax regimes, in general, require the company to engage in actual business in order to generate economic growth they are very likely to comply with the substantial activity requirement set forth by the “*nexus approach*” and are, therefore, not to be considered harmful tax practices encountered by BEPS Action 5. Rather, given the underlying requirement of sufficient activities for the preferential tax regimes to apply, such mismatches merely reflect different judgements about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country’s sovereignty in fiscal matters. As a

²⁰⁶ See Section 3.1.

²⁰⁷ See Section 3.1.

consequence, and due to the lack of fundamental harmonisation of tax legislations across jurisdictions, mismatches in tax outcomes will continue to exist.

4 CONCLUSION – THE EXISTING MISMATCHES IN TAX OUTCOMES IN THE LIGHT OF BEPS ACTIONS 2 AND 5

Given the different approaches with regard to income taxation and the discrepancies with respect to the underlying policy considerations, the tax legislation around the globe varies significantly. As has been shown in this paper, this is due to a number of reasons, such as the lack of a legal obligation and the – political – unwillingness of sovereign legislators to harmonise the income tax systems as well as the different needs and policy considerations that have to be taken into account when designing the domestic tax systems. Therefore, mismatches in tax outcomes are not limited to the avoidance of hybrid mismatch arrangements but are, in fact, a multi-faceted issue.

Against this background, the purpose of the BEPS project of the OECD is, *inter alia*, to eliminate international double non-taxation caused by such mismatches while, at the same, avoiding the creation of unintended double taxation. Regarding the issue of mismatches in tax outcomes, special attention has to be given to BEPS Actions 2 and 5. As a closer analysis reveals, the recommendations of the OECD with respect to the domestic law under BEPS Action 2 seem to have, in fact, significant potential to effectively address the issue of hybrid mismatch arrangements. However, given the lack of a legal obligation to introduce and apply the proposed measures in a coordinated manner, inconsistencies in how different countries implement the various recommendations are likely to occur. As a consequence, it remains doubtful whether the recommendations will achieve their underlying aim, *i.e.* to ensure single taxation of cross-border payments. This applies all the more as the recommendations of the OECD are dealing with the underlying qualification conflict with regard to the hybrid arrangements but are, on the contrary, limited to the neutralisation of the effects resulting therefrom. Thus, mismatches stemming from the differences in domestic rules relating to the classification of entities and financial instruments will continue to exist. Furthermore, there are a number of conceivable D/NI-outcomes that are not due to a hybrid mismatch arrangement and are, therefore, outside the scope of BEPS Action 2.

Mismatches in tax outcomes may also be the result of the application of preferential tax regimes at the level of the recipient of the payment. Against this background, the OECD deals

with the distinction between harmful tax practices and justified preferential tax regimes in the course of BEPS Action 5 thereby specifically requiring substantial activity for any preferential regime. Based on the understanding that the substantial activity requirement used to assess preferential regimes should be strengthened in order to realign taxation of profits with the substantial activities that generate them, BEPS Action 5 proposes the so-called “nexus approach”. According to this concept, preferential regimes are found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime. However, it has to be noted that such preferential tax regimes are an important tool for countries to offset non-tax disadvantages in order to attract foreign business investors thereby increasing the number of enterprises resident in that state. This is especially true for countries with specific structural disadvantages, such as poor geographical location or the lack of natural resources. Given these underlying tax policy considerations, it remains doubtful whether this approach will be comprehensively followed by sovereign tax legislators.

In summary, considering the final results of the work on BEPS Actions 2 and 5, one could not help but notice that they are targeted at tackling the symptoms of the issues instead of dealing with the root causes of unintended mismatches in tax outcomes, *i.e.* to eliminate the existing disparities between national tax systems. Furthermore, due to their specific aim, BEPS Actions 2 and 5 provide for a limited scope. Accordingly, mismatches in tax outcomes are only considered unintended or harmful and are thus covered, if they are due to the use of a hybrid mismatch arrangement or a preferential tax regime failing to comply with the substantial activity requirement. As a consequence, and due to the lack of fundamental harmonisation of tax legislations across jurisdictions, mismatches in tax outcomes will continue to exist.

At the same time, it has to be noted that, at present, the economies around the globe are at different stages of development. As it regards the use of preferential tax regimes, for developing economies or jurisdictions with limited geographical or personal resources, such tax incentives may be crucial in order to attract foreign investments. As a result, and bearing in mind these different tax policy considerations of sovereign tax legislators, the intended establishment of international coherence in corporate income taxation is unlikely to be achieved.

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