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Cover Page Footnote
J.D. Candidate, May, 2016, The Catholic University of America, Columbus School of Law. B.A., 2013, Gettysburg College. The author would like to thank his parents Charles and MaryJane Harris for their love and support throughout law school. The author would also like to thank the editors on the Catholic University Law Review for their excellent work.

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INTERNATIONAL TAX IMPLICATIONS OF THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT PROPOSAL TO NEUTRALIZE HYBRID MISMATCH ARRANGEMENTS

Dean Harris[+]

In 2011, Apple paid only $3.3 billion of its $34.2 billion worldwide income in taxes.[1] This equates to a tax rate of 9.8%.[2] This is roughly the same tax rate that an individual with an annual salary of $8,500 would pay in federal income tax in the United States.[3]

To accomplish this favorable tax treatment, Apple used international tax structures such as hybrid mismatch arrangements, transfer pricing, and special agreements with certain jurisdictions.[4] Such tax structuring is nothing new, but in recent years it has received increased media attention.[5] This attention has led

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1. Arnaud de Graaf, Paul de Haan & Maarten de Wilde, *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS*, 42 INTERTAX 306, 312 (2014).

2. *Id.* Similarly, in 2013, Ford Motor Company achieved a staggering negative two and one-half percent worldwide tax rate, making it the only S&P 100 to have a negative tax rate and therefore due a tax refund. John S. Kiernan, *S&P 100 Tax Rate Report*, WALLETHUB (Oct. 11, 2014), http://wallethub.com/edu/2013-corporate-tax-report/6768/. Other corporations, however, such as Devon Energy, found themselves on the opposite end of the spectrum with an overall international tax rate of 113.5%. *See id.*

3. *See* THOMAS A. BARTHOLD, JOINT COMMITTEE ON TAXATION, TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION, 16 tbl. 2 (JCX-49-11, 2011), https://www.jct.gov/publications.html?func=startdown&id=4363; *see also* Kelly Phillips Erb, *Making Sense of Income and Tax Terms*, FORBES (Nov. 13, 2012, 7:47 AM), http://www.forbes.com/sites/kellyphillipserb/2012/11/13/making-sense-of-income-and-tax-terms/#32dae716fbda (listing federal income tax rates for single individuals and heads of households in 2011). Although a citizen in this tax bracket is realistically unlikely to owe federal income tax, this chart allows for a good comparison. *See generally* Brad Plumer, *Who Doesn't Pay Taxes, in Eight Charts*, WASH. POST (Sept. 18, 2012), https://www.washingtonpost.com/news/wonk/wp/2012/09/18/who-doesnt-pay-taxes-in-charts/ (indicating that many poor workers do not owe federal income tax due in part to various exemptions in the federal tax code).

4. *See* Graaf, Hann & Wilde, *supra* note 1, at 312; *see also* The Editorial Bd., *Apple's Special Irish Tax Breaks*, N.Y. TIMES (Sept. 30, 2014), http://www.nytimes.com/2014/10/01/opinion/apples-special-irish-tax-breaks.html?_r=0 (stating that Apple had special agreements with countries such as Ireland, which allowed the company to avoid certain tax regulations).

5. *See* Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES (Apr. 28, 2012), http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?_r=0 (stating that Apple was one of the first corporations to use a structure called a "Double Irish With a Dutch Sandwich," allowing the company to use Irish

to scrutiny from both government and non-govermenental organizations, and several multinational corporations now stand accused of dodging taxes.[6]

In response to these accusations, and in an attempt to promote fair policies and close loopholes in international taxation, the Organisation for Economic Co-operation and Development (OECD) created the Base Erosion and Profit Shifting (BEPS) action plan.[7] This Comment focuses on BEPS Action 2: "Neutralize the Effect of Hybrid Mismatch Arrangements."[8]

The BEPS action plan made hybrid mismatch arrangements a main focus because such arrangements allow corporations to achieve double non-taxation.[9] Double non-taxation occurs when a multinational corporation does not pay income tax on a certain transaction or instrument in either jurisdiction in which the transaction occured.[10]

To accomplish double non-taxation with a mismatch arrangement, a company finds two nations that treat the same financial instrument differently, so that a single instrument has different tax outcomes and, as a result, the company can

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subsidiary companies to write off profits and achieve large tax breaks); *see also* Editorial Bd., *Apple is Shifting Its Tax Burden*, WASH. POST (May 21, 2013), http://www.washingtonpost.com/opinions/apple-is-shifting-its-tax-burden/2013/05/21/a3a81404-c24f-11e2-9fe2-6ee52d0eb7c1_story.html; David Kocieniewski, *But Nobody Pays That; At G.E. on Tax Day, Billions of Reasons to Smile*, N.Y. TIMES (Mar. 25, 2011), http://query.nytimes.com/gst/fullpage.html?res=9E07E5DE1131F936A15750C0A9679D8B63&module=Search&mabReward=relbias%3Ar%2C%7B%222%22%3A%22RI%3A17%22%7D; Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion is Lost to Tax Loopholes*, BLOOMBERG NEWS (Oct. 21, 2010), http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html; Margaret Heffernan, *Why Starbucks' Tax Claims Don't Wash*, CBS NEWS (Nov. 13, 2012), http://www.cbsnews.com/news/why-starbucks-tax-claims-dont-wash/.

6. *See* Graaf, Hann & Wilde, *supra* note 1, at 312; *see also* Doug Bolton, *Apple CEO Tim Cook Dismisses Tax Avoidance Allegations as "Total Political Crap*," INDEP. (Dec. 21, 2015), http://www.independent.co.uk/life-style/gadgets-and-tech/news/apple-tim-cook-tax-avoidance-total-political-crap-a6781601.html (discussing Apple's disagreement with the U.S. government over whether it has paid its full tax burden).

7. *See* Pascal Saint-Amans & Raffaele Russo, *What the BEPS are We Talking About?* OECD (2013), http://www.oecd.org/tax/what-the-beps-are-we-talking-about.htm; *see also* Graaf, Hann & Wilde, *supra* note 1, at 311–12 (explaining how a base erosion or profit shifting strategy is created and achieves favorable tax outcomes). The OECD is an international organization that seeks to "promote policies that will improve the economic and social well-being of people around the world," and aims to "set international standards on a wide range of things, from agriculture and tax to the safety of chemicals." OECD, http://www.oecd.org/about/ (last visited Feb. 17, 2016).

8. *See generally* OECD, PUBLIC DISCUSSION DRAFT: BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (2014), http://www.oecd.org/tax/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf [hereinafter OECD, BEPS ACTION 2]. The BEPS Action Plan was endorsed by the G20 members in September 2013 and proposes various measures designed to nullify the impact of hybrid mismatch arrangements. *Id.* at 5–6.

9. *See id.* at 8–9.

10. *See id.*; *see also Fighting Unintended Double Non-Taxation*, OECD (Nov. 5, 2012), http://www.oecd.org/ctp/aggressive/fightingunintendeddoublenon-taxation.htm.

deduct income from the instrument from its taxes in both jurisdictions.[11] This is called a "double deduction."[12] A company can also create a mismatch arrangement when one jurisdiction allows the company to deduct a certain instrument—such as a loan—from its income, while a second jurisdiction does not classify the instrument as income, and the company consequently does not report funds derived from the instrument as income.[13] This is called a "deduction/no inclusion" or "indirect deduction/no inclusion."[14]

The OECD's plan focuses on six types of arrangements that companies use to create mismatch outcomes: 1) hybrid financial instruments; 2) hybrid disregarded payments; 3) reverse hybrids; 4) deductible payments made by a hybrid; 5) deductible payments made by a dual resident; and 6) imported mismatches.[15]

The OECD, describing the various devices that companies use to create such arrangements and identifying solutions to the problems that such arrangements cause, proposes that member states change their domestic laws to curtail mismatch arrangements.[16] The proposal is intended to "target only instruments and entities that are hybrids for tax purposes and adjust only the tax outcomes under those arrangements."[17] This represents a new approach to hybrids, which

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11. *See* OECD, BEPS ACTION 2, *supra* note 8, at 8–9.

12. *See* OECD, BASE EROSION AND PROFIT SHIFTING PROJECT: NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS 14, 18 (2014), http://dx.doi.org/10.1787/9789264218819-en [hereinafter OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS].

13. *Id.* at 15. The company can then shift the resulting income into a third jurisdiction through instruments such as loans. *Id.*

14. *Id.* at 14–15; *see also* PRICEWATERHOUSECOOPERS, OECD REPORT ON ACTION 2-HYBRID MISMATCHES 2 (Oct. 10, 2014), https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-beps-hybrid-mismatches.pdf (discussing "indirect deduction/no income" arrangements).

15. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 17.

16. *See id.*; *see also* Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 69 (2014); David L. Cameron & Thomas Kittle-Kamp, *Federal Income Taxation of Intellectual Properties and Intangible Assets*, FED. INC. TAX. INTELL. PROP. & INTANGIBLE ASS. ¶ 14.11 (2014) (discussing the various "action items" that the OECD proposal addresses).

17. *See generally* OECD, BEPS ACTION 2, *supra* note 8. Four previous OECD reports, in 1999, 2010, 2011, and 2012, addressed mismatch arrangements. *Id.* at 4, 6–7. The 1999 OECD report on partnerships was an early attempt at addressing hybrid mismatch arrangements using changes to the OECD model tax convention. *Id.* at 6. However, the report focused solely on how mismatches affected partnerships. *Id.* While this document shed light on mismatches, it allowed "fiscally transparent" non-partnership entities to continue to exploit various mismatch arrangements. *Id.* at 4, 6–7.

Despite its limited focus, the 1999 report provided helpful insight for the new hybrid Action regarding treaty analysis and implementation. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 85–86. However, it did not address treaties in other contexts, and since it was published, several nations have struggled to implement and apply the report's suggestions. *Id.*

focuses on payments to and from hybrid entities that create double non-taxation.[18] The proposal also presents new ideas about including interested parties and introduces new rules to eliminate mismatch arrangements.[19] Specifically, the OECD plan states that its purpose is to target instruments "where the resulting mismatch results in a lower aggregate tax burden for the parties to the arrangement."[20] This Comment argues that OECD's proposed changes in domestic law will not solve the problems posed by hybrid mismatch arrangements and will instead target other legal structures involving hybrids that are not necessarily a function of the aggressive tax planning structures under media and governmental scrutiny.[21]

The 2010 and 2011 reports superficially addressed hybrid mismatches, but laid the groundwork for an overhaul of tax structures by showing the dangers that mismatch arrangements present. *See generally* OECD, ADDRESSING TAX RISKS INVOLVING BANK LOSSES 27-28 (2010), http://www.oecd.org/tax/aggressive/46023583.pdf [hereinafter OECD, ADDRESSING TAX RISKS INVOLVING BANK LOSSES] (discussing the revenue loss that results from corporate utilization of hybrid mismatch arrangements); OECD, CORPORATE LOSS UTILIZATION THROUGH AGGRESSIVE TAX PLANNING 57 (2011), http://dx.doi.org/10.1787/9789264119222-en (explaining how companies use hybrids to exploit tax law inconsistencies in multiple jurisdictions, resulting in revenue loss). In spite of national governments' inability to capture revenue because of corporate utilization of hybrid mismatch arrangements, the OECD largely left it to national governments to tackle the problem, simply recommending that revenue bodies "bring to the attention of their government . . . situations . . . where the same tax loss is relieved in more than one country as a result of differences in tax treatment . . . to eliminate that arbitrage/mismatch opportunity." OECD, ADDRESSING TAX RISKS INVOLVING BANK LOSSES, *supra* at 5.

The 2012 report represented a significant attempt to target the use of mismatch arrangements by corporations. *See* OECD, HYBRID MISMATCH ARRANGEMENTS: TAX POLICY AND COMPLIANCE ISSUES 5–6 (2012), http://www.oecd.org/ctp/exchange-of-tax-information/HYBRIDS_ENG_Final_October2012.pdf [hereinafter OECD, TAX POLICY AND COMPLIANCE ISSUES]; OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 23. The OECD released this report in 2012 because an increasing number of nations were growing concerned with mismatches. OECD, HYBRID MISMATCH ARRANGEMENTS: TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 5. Countries had been struggling with these arrangements for years leading up to the 2012 report. *Id.* For example, New Zealand paid out its largest settlement in history because of mismatch arrangements involving banks and Italy settled a multitude of cases, costing the country approximately $1.5 billion. *Id.* In the report, the OECD laid out a multitude of ideas on how to deal with the tax avoidance problems posed by hybrid mismatch arrangements, including harmonizing domestic law, implementing anti-avoidance rules, and promulgating rules specifically addressing mismatch arrangements. *Id.* at 13–14.

18. *See* OECD, BEPS ACTION 2, *supra* note 8, at 8; OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 10, 13 (2013), http://www.oecd.org/ctp/BEPSActionPlan.pdf [hereinafter OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING]; Tom Bergin, *OECD Unveils Proposals to Curb Corporate Tax Avoidance*, REUTERS (Sept. 16, 2014), http://www.reuters.com/article/us-oecd-tax-idUSKBN0HB18V20140916.

19. *See* OECD, BEPS ACTION 2, *supra* note 8, at 8; OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra* note 18, at 24.

20. *See* OECD, BEPS ACTION 2, *supra* note 8, at 8.

21. *See, e.g.*, HM TREASURY & HM REVENUE & CUSTOMS, TACKLING AGGRESSIVE TAX PLANNING: IMPLEMENTING THE AGREED G20-OECD APPROACH FOR ADDRESING HYBRID MISMATCH ARRANGEMENTS, 37 (Dec. 2014), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382382/tackling_aggressive_tax_planning_hybrids_mismatch_arran

This Comment begins by laying out what a hybrid mismatch arrangement is and the problems that such arrangements present. Next, it discusses the Irish approach to hybrids, and how companies use Irish law to lower their tax liabilities. This Comment then analyzes a variety of international and domestic approaches to hybrid mismatches, focusing specifically on the United States and the United Kingdom. Next, the Comment focuses on the various approaches of domestic legislation, the OECD proposal, and how companies like Apple have leveraged each to their advantage. Finally, it proposes that the OECD address changing bilateral treaties rather than the implementation of domestic legislation.

I. WHAT IS A HYBRID MISMATCH ARRANGEMENT?

Defining a hybrid mismatch arrangement can be difficult because jurisdictions have not agreed on a singular definition. It is possible to achieve a more comprehensive understanding by looking at several definitions.[22]

Broadly, a hybrid mismatch arrangement occurs when a multinational corporation achieves a double deduction or deduction/no inclusion by creating a mismatch in its tax outcomes in two different nations.[23] More narrowly, "hybrid mismatch arrangements incorporate techniques that exploit a difference in the

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gements_consultation_final.pdf (stating that the OECD proposal may negatively affect intra-group financing arrangements that treat securities as regulatory capital but are unrelated to tax purposes); ERNST & YOUNG GLOBAL LTD., GLOBAL BANKING AND CAPITAL MARKETS: BEPS ACTION POINT 2 ON HYBRID MISMATCH ARRANGEMENTS: IMPLICATIONS FOR BANKS 4–5 (2014), http://www.ey.com/Publication/vwLUAssets/EY-beps-action-point2-on-hybrid-mismatch-arrangements/$FILE/EY-tax-news-2016061703.pdf [hereinafter ERNST & YOUNG GLOBAL LTD.: BEPS ACTION POINT 2 ON HYBRID MISMATCH ARRANGEMENTS] (explaining that if the full proposal is implemented, some banks may need to reconsider whether many of their borrowing instruments could be construed as hybrid financial instruments and monitor how each holder of a given instrument treats the instrument for tax purposes). While this Comment discusses a number of types of hybrids, at its basic level a hybrid mismatch arrangement is a type of financial instrument that "exploit[s] asymmetries between different tax jurisdictions." *Hybrid Mismatches – UK Proposals for Implementing the BEPS Recommendations*, MCDERMOTT WILL & EMERY (Dec. 17, 2014), http://www.mwe.com/Hybrid-Mismatches-UK-Proposals-for-Implementing-the-BEPS-Recommendations-12-16-2014/?PublicationTypes=d9093adb-e95d-4f19-819a-f0bb5170ab6d.

22. *See* Stanley C. Ruchelman, *Neutralizing the Effects of Hybrid Mismatch Arrangements: The New OECD Discussion Drafts Regarding Base Erosion and Profit Shifting*, 27 J. TAX'N. & REG. F. INST. 25, 26 (2014), http://publications.ruchelaw.com/pdfs/2015-11/JoTRFI-Neutralizing HybridMismatch.pdf (providing important background information on hybrid mismatch arrangements in international taxation and defining hybrids as "transactions where a payment is made under a financial instrument[and] [t]he payor claims a deduction in its jurisdiction of residence, but payment is not subject to withholding tax, and the related recipient is treated in its jurisdiction of residence as if no taxable income is received"). *See generally* OECD, BEPS ACTION 2, *supra* note 8, at 8–9 (discussing different types of arrangements).

23. OECD, BEPS ACTION 2, *supra* note 8, at 8.

characterisation of an entity or arrangement under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes."[24]

There are three main types of desirable tax outcomes stemming from mismatch arrangements: double deductions; deduction/no inclusions; and indirect deduction/no inclusions.[25] Double deductions are "payments that give rise to duplicate deductions from the same expenditure."[26] Deduction/no inclusions are "payments that are deductible under the rules of the jurisdiction of the payer and not included in the income of the recipient."[27] Indirect deduction/no inclusions arise through the use of imported mismatches.[28] Using a basic instrument such as a regular loan, the arrangement exploits a lack of mismatch regulation in an investor jurisdiction to create a deduction/no inclusion arrangement.[29]

Companies use three main types of instruments to create these desirable tax outcomes: hybrid financial instruments and transfers, hybrid entity payments, and reverse hybrids and imported mismatches.[30] Each instrument works in a different way to benefit a taxpayer and can be used alone or in conjunction with another instrument.[31]

A. Hybrid Financial Instruments and Transfers

This type of hybrid mismatch arrangement involves a financing arrangement that is subject to two different classifications in two or more jurisdictions,[32]

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24. *Id.* The OECD states that the extent of a hybrid mismatch is found "by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises." OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 29.

25. *See* OECD, BEPS ACTION 2, *supra* note 8, at 8–9; *see also* PRICEWATERHOUSECOOPERS, OECD REPORT ON ACTION 2-HYBRID MISMATCHES, *supra* note 14, at 2.

26. OECD, BEPS ACTION 2, *supra* note 8, at 8. In federal income tax, this would be the equivalent of being able to include the same item on your taxes as two different deductions. *See* 26 U.S.C. §§ 162(a) *et seq.*, 212 *et seq.* (2012) (providing for deductions for business expenses and production of income expenses).

27. OECD, BEPS ACTION 2, *supra* note 8, at 8.

28. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 59.

29. *Id.* at 59.

30. *See generally id.* at 17, 25, 55, 84–89, 158 (describing and providing recommendations on the different types of financial instruments that companies avail themselves of).

31. *See id.*; *see also* ERNST & YOUNG GLOBAL LTD.: BEPS ACTION POINT 2 ON HYBRID MISMATCH ARRANGEMENTS , *supra* note 21, at 2; Ruchelman, *supra* note 22, at 26–27.

32. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 33–34; *see also* DELOITTE, UNITED STATES TAX ALERT: OECD RELEASES BEPS DRAFT ON HYBRID MISMATCH ARRANGEMENTS (2014), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-unitedstates-040414.pdf [hereinafter DELOITTE, OECD RELEASES BEPS DRAFT ON HYBRID MISMATCH ARRANGEMENTS] (providing an example of financial instruments in which "the payment . . . is deductible as debt in one taxing jurisdiction and taxed as a dividend disitribution in another taxing jurisdiction").

resulting in a deduction/no inclusion.[33] The most common forms of this instrument are loans.[34] For example, one jurisdiction treats the loan as deductible debt while the other jurisdiction treats it as equity and taxes it as a dividend distribution.[35] One jurisdiction, therefore, does not treat the instrument as taxable income.[36]

The most effective and widely used instrument that the OECD examines in its report is the collateralized "repo" loan.[37] This type of agreement involves a sale and repurchase of an asset from the same company.[38] The repurchasing company creates a mismatch because one jurisdiction views the deal as a sale, essentially disregarding the buyback of the asset, and the other jurisdiction views it as a loan, subjecting it to the same treatment it would normally give a loan.[39]

A typical repo loan involves three parties: two parent companies and at least one subsidiary company.[40] The OECD states that a collateralized repo loan works in the following manner:

> A sells the shares of B Sub to B Co under an arrangement that A Co (or an affiliate) will acquire those shares at a future date for an agreed price. Between sale and repurchase, B Sub makes distributions on the shares to B Co. . . . The net cost of the repo to A Co is treated as a deductible financing cost. A Co's cost includes the B Sub dividends that are paid to and retained by B Co. Country B will typically grant a credit, exclusion, exemption or some other tax relief to B Co on the dividends received. B Co also treats the transfer of the shares back to A Co as a genuine sale of shares and may exempt any gain on disposal under an equity participation exemption or a general exclusion for capital gains. The combined effect of the repo transaction is, therefore, to generate a deduction for A Co in respect of the aggregate payments made under the repo with no corresponding inclusion for B Co.[41]

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33. *See* DELOITTE, OECD RELEASES BEPS DRAFT ON HYBRID MISMATCH ARRANGEMENTS, *supra* note 32.

34. *See* OECD, BEPS ACTION 2, *supra* note 8, at 20–23 (listing several types of instruments that create such an arrangement, including but not limited to: collateralized repo loans, share lending repo loans, double dips on withholding tax credits, and certain loans from tax exempt organizations).

35. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 33–34.

36. *See id.*; *see also* DELOITTE GLOBAL, BEPS ACTION 2: HYBRID MISMATCH ARRANGEMENTS (2014), https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Tax/beps_action_2.pdf.

37. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 34.

38. *Id.*

39. *Id.* at 34–35.

40. *Id.* at 35.

41. *Id.*

These instruments are popular for international tax planning because they allow companies to implement a deduction/no inclusion scheme while obtaining tax credits.[42]

B. Hybrid Entity Payments

Hybrid entity payments exploit a difference in views on how a given taxpaying entity should be classified.[43] These arrangements can result in either a double deduction, or a deduction/no inclusion.[44] The most basic use of this instrument involves the use of hybrid subsidiaries that are transparent for tax purposes in one jurisdiction, but not in another.[45]

The OECD illustrates a basic double deduction structure using a common hybrid entity technique: Company A holds all shares of its foreign-based subsidiary Company B, a hybrid entity, which is not taxed by the country in which Company A resides.[46] Company B proceeds to take out a loan and pays interest, but has no other income of any kind.[47] Because Company B is not taxed in the country in which Company A, its parent company, is based, Company A is seen as the borrower.[48] Company B then works through a subsidiary to "surrender the tax benefit of the interest deduction," enabling Company A to treat the interest as separate income in countries A and B, resulting in a double deduction.[49]

C. Reverse Hybrids and Imported Mismatches

A basic imported mismatch using a hybrid financial instrument involves the creation of a hybrid structure under two jurisdictions, which is then "imported" into a third jurisdiction.[50] Imported mismatches can be quite complex, often involving several companies and jurisdictions.[51] Reverse hybrids, structures

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42. *See* Ruchelman, *supra* note 22, at 26 (explaining that the "effect of the repo transaction is . . . to generate a deduction for [one company] in respect of the aggregate payments made under the repo with no corresponding inclusion for [the other company]").

43. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 29.

44. *Id.*

45. *See* Ruchelman, *supra* note 22, at 28.

46. OECD, BEPS ACTION 2, *supra* note 8, at 44–45; Ruchelman, *supra* note 22, at 28.

47. Ruchelman, *supra* note 22, at 28.

48. *Id.*

49. *Id.*

50. *See* OECD, BEPS ACTION 2, supra note 8, at 57; OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 59.

51. *See generally id.* at 58–60. A good example comes from OECD's draft which states an imported mismatch would occur when:

> B Co is a wholly-owned subsidiary of A Co. A Co lends money to B Co using a hybrid financial instrument. The payments under this instrument will be exempt from tax under the laws of Country A, while being deductible under the laws of Country B. Borrower Co borrows money from B Co. Interest payable under the loan is deductible under the

result in an indirect deduction/no inclusion,[52] are a more specific subset of this instrument.[53]

For imported mismatch structure to apply, either the parties involved in the arrangement must be in the same control group, or there must be a structured arrangement to which all of the groups are a party.[54] The OECD admits that rules regarding imported mismatches are not flawless, and more research is needed to ensure that double taxation does not remain an issue under new regulations.[55]

1. Why Are Mismatch Arrangements Such a Problem?

As discussed previously in this Comment, double non-taxation is a major problem in international tax structuring because countries should be entitled to tax income earned within their respective jurisdictions, something that these arrangements prevent.[56]

Hybrid mismatch arrangements present a unique problem within double non-taxation structures because of how difficult it is to track such arrangements.[57] It is hard to pinpoint when, where, and if a company is using a mismatch arrangement.[58] Further exacerbating this problem, government entities are hard-

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> laws of Borrower Co's jurisdiction (Country C) and included in income by B Co under Country B law. The result of this structure is an indirect D/NI outcome between Countries A and C. Country B's tax revenue is unaffected as the income and deductions of B Co offset each other.

Id. at 58.

52. OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 59.

53. *See* OECD, BEPS ACTION 2, supra note 8, at 57.

54. OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 59–60. Under the OECD proposal, parties are part of the same control group if one of four factors are met: 1) two persons are "consolidated for accounting purposes;" 2) one person has an investment that gives them control over the second or third person in a transaction; 3) 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;" and 4) the two groups can be defined as "associated enterprises" under Article 9 of the OECD model tax convention, or a tax treaty that has adopted the rules of article 9. *Id.* at 69.

55. *Id.* at 11 (stating that "there are a number of specific areas where the recommended domestic rules . . . may need to be further refined"). In the global business context, "double taxation occurs when more than one country has and exercises jurisdiction to impose an income tax on the same income." Yoseph Edrey Adrienne Jeffrey, *Taxation of International Activity: Over Relief from Double Taxation Under the U.S. Tax System*, 9 INT'L TAX & BUS. LAW. 101, 102 (1991).

56. *See generally* Joseph B. Darby III & Kelsey Lemaster, *Double Irish More than Doubles the Tax Saving: Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation*, PRAC. US/INT'L TAX STRATEGIES, May 15, 2007, at 2 (discussing U.S. efforts to prevent corporations from avoiding or deferring taxes in order to capture revenue).

57. *See* OECD, BEPS ACTION 2, *supra* note 8, at 4.

58. *See generally* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 30–31 (discussing the difficulties of detecting the operation of a hybrid financial instrument).

pressed for time and resources,[59] while researching whether an arrangement is being used to create a mismatch or is simply a regular instrument is resource-intensive endeavor.[60] Additionally, it is often difficult to discern which country is losing tax revenue under a given arrangement.[61]

II. THE IRISH APPROACH

Multinational corporations frequently use Ireland as a destination for aggressive tax planning.[62] Ireland's rules regarding mismatch arrangements give considerable leeway in comparison to those of other nations, such as the United States.[63] Ireland plays a large role in hybrid mismatch arrangements, and its unique legislation regarding interest and loans is especially pertinent.[64]

A. Interest as a Trading Expense

Ireland allows a deduction for any interest solely for the purpose of trades.[65] For interest to be considered a trading expense, it must not have a capital nature, but even if it does, it can still be deducted if the interest would be otherwise deductible.[66]

These deductions have been considered by the Irish courts, as seen in *MacAonghusa v. Ringmahon Co*.[67] In this case, Ringmahon acquired a number of supermarkets through an intercompany loan, which was replaced by preference shares.[68] Ringmahon then obtained a bank loan solely for the purpose of redeeming those preference shares.[69] The Supreme Court of Ireland allowed the company to write off the interest as a deduction because it was solely a trade-based interaction.[70] The company successfully argued that because no new instrument or asset had been acquired, it could get rid of share capital and

59. See *id.*; *see also* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 736 (2011).

60. *See* Kleinbard, *supra* note 59, at 736.

61. *See* OECD, BEPS ACTION 2, *supra* note 8, at 4.

62. *See* Darby & Lemaster, *supra* note 56, at 12.

63. *See id.*; *see also* Danielle Kurtzleben, *The Global Race to the Bottom in Corporate Taxes*, U.S. NEWS (July 13, 2013), http://www.usnews.com/news/articles/2013/07/23/charts-the-global-race-to-the-bottom-in-corporate-taxes.

64. *See, e.g.*, Taxes Consolidation Act, 1997 §§ 82(2), 243, 246(3), 247, 249 (Ir.); *see also infra* Part II.

65. *See* Taxes Consolidation Act, 1997 § 82(2) (Ir.) (noting that interest reduction schemes such as this can be used to facilitate collateralized repo loans, a major part of BEPS: Action 2); *see also* OECD, BEPS ACTION 2, *supra* note 8, at 20.

66. *See* Taxes Consolidation Act, 1997 §§ 80(1), 81(2)(f), (h), 82(1)–(3) (Ir.).

67. [2001] 2 IR 507 (Ir.), http://www.supremecourt.ie/Judgments.nsf/60f9f366f10958d1802572ba003d3f45/ceeb2b2eadc6a75180256ccc004f2398?OpenDocument&Highlight=0,MacAonghusa%20.

68. *Id.*

69. *Id.*

70. *Id.*

continue its business by using bank loans on which to pay interest, thereby allowing the deduction.[71]

B. Interest as a Charge

Where a company has interest from obtaining shares in, or loaning money to, other companies, it can be deducted as "interest as a charge."[72] Whether a foreign company pays income taxes on a transaction with an Irish company has no impact on the deductibility of interest from the Irish company.[73]

Companies can also combine the strategies of interest solely for the purpose of a trade and interest as a charge to further take advantage of double deductions on interest.[74] For instance, it is possible for an investing company to give money to a trading institution and, under current statutory provisions, it is unclear whether the loan has to be used for its lifetime in the trade of the company or it could be used for trade purposes on the first day of its installment, and that would be sufficient to constitute it as interest as a charge; thereby, later changing its purpose but nevertheless acquiring interest deductions.[75]

Ireland's corporate tax law played a large part in Apple's ability to achieve its low overall income tax rate.[76] Apple paid a mere two percent income tax in Ireland in 2013, leading the European Union (EU) to assert that Ireland violated portions of the EU treaty by allowing Apple to use aggressive tax planning strategies, such as hybrid mismatch arrangements.[77]

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71. *Id.*

72. Taxes Consolidation Act, 1997 § 243(9) (Ir.); *see also id.* §§ 247, 249 (Ir.). Section 247 lays out requirements for interest as a charge, which must meet all of the requirements previously set out in Section 243. *See id.* at § 247. Furthermore, Section 249 is only applicable in recovery of capital situations in regards to a Section 247 loan. *See id.* at § 249. So, in theory, a mismatch is possible using these sections. For further explanation regarding interest as a charge, see generally Lorraine Griffith, Deloitte Ireland, *Section 247-The Devil's in the Detail*, *in* IRISH TAX INST., ANN. CONF. 203-21 (2013).

73. *See* Taxes Consolidation Act, 1997 § 246(3) (Ir.).

74. *See* Griffith, *supra* note 72, at 212–13, 217.

75. *See id.* at 212. Simply called the "Day [One]" test; this question remains up for debate. *Id.* Companies have been able to use such a situation to achieve a deduction; however, the future of these installments is unclear. *Id.*

76. *See supra* text accompanying note 1.

77. *See Apple's Special Irish Tax Breaks*, *supra* note 4. The Irish government had its reasons for giving Apple the tax treatment that it did, as Apple is one of the largest employers in certain parts of Ireland, especially County Cork, where it employs 4,000 people. *Id.* Tax professionals have likened Ireland's treatment to many American cities and states willing to give tax breaks in turn for job creation. *Id.*; *see also* Julia Fioretti & Tom Bergin, *EU Says Ireland Swapped Apple Tax Deal for Jobs*, REUTERS (Sept. 30, 2014, 1:50 PM), http://www.reuters.com/article/2014/09/30/us-apple-ireland-tax-idUSKCN0HP0QT20140930.

III. SOLUTIONS TO HYBRID MISMATCH ARRANGEMENTS

A. United States Legislation

The United States addresses several types of mismatch arrangements both in domestic legislation and in treaties with other nations. The United States targets double deductions and losses through Section 1503(d) of the Internal Revenue Code.[78]

Dual resident corporations cannot take a single loss to offset income subject to a U.S. tax and then do so again for income subject to a foreign tax.[79] A corporation may not use a dual consolidated loss—defined in part as "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country,"—which would be used to offset income from a "domestic affiliate."[80]

The United States also instituted rules for minimizing the effect of foreign tax credit abuse.[81] Under Section 909 of the Internal Revenue Code, a foreign tax credit splitting event has occurred if an entity pays a foreign tax, but that income is used to pay taxes taken into account by another entity known as a covered person.[82] If such an event occurs, the paid foreign tax will not be taken into

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78. 26 U.S.C. § 1503(d) (2012). A dual consolidated loss is defined as "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis." *Id.*

79. *See id.* at § 1503(d)(2)(A). The OECD states a dual consolidated company would create a double deduction in this manner:

> A Co (a company incorporated and tax resident in Country A) holds all the shares in B Co (a company incorporated in Country B but tax resident in both Country A and Country B). B Co owns all the shares in B Sub 1 (a company tax resident and incorporated in Country B). B Co is consolidated, for tax purposes, with both A Co (under Country A law) and B Sub 1 (under B Country Law).

OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 55.

80. 26 U.S.C. § 1503(d)(2); *see also* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 55–57.

81. 26 U.S.C. § 909 (2012). This issue arose with regard to multinational corporations acquiring excess foreign tax credits. *See* BLOOMBERG TAX AND ACCOUNTING CTR., U.S. TAX OVERVIEW, STRUCTURE OF THE FEDERAL TAX SYSTEM OF THE UNITED STATES, CH. XIV. U.S. INTERNATIONAL TAXATION, (F) THE FOREIGN TAX CREDIT (2014), https://taxandaccounting.bna.com/btac/T1900/split_display.adp?fedfid=17877948&vname=tmetpor&fcn=58&wsn=501982086&fn=17877948&split=0. After all domestic taxes were paid and credited, then the taxpayer would be able to credit even more foreign tax, and could structure its arrangements to receive large amounts of credits on rather small amounts of income. *Id.* Taxpayers have utilized hybrid arrangements placing foreign taxes under the purview of a high-tier entity, while income is consolidated in a low-tier entity. *Id.* The foreign tax entity would then send earnings back to the U.S., taking advantage of the foreign taxes as a credit. *Id.*

82. 26 U.S.C. § 909(d)(1), (d)(4) (2012) (regarding the tax paying entity, under § 909(d)(4), a covered person is: (1) an entity owned ten percent or more by the payer; (2) an entity that owns

account for U.S. tax purposes until the tax paying entity takes into account the income on which those taxes were paid.[83]

The IRS identified four arrangements that Section 909 would affect for pre-2011 years, and that could possibly be added for years post-2010.[84] These instruments included: (1) reverse hybrids in which one entity pays tax for the other entity; [85] (2) foreign consolidated groups which do not allocate consolidated foreign taxes to accord for each member's share; (3) group or other loss-sharing arrangements;[86] and (4) hybrid instruments.[87]

In addition to domestic legislation, the United States addresses mismatch issues in bilateral treaties.[88] The 1989 United States treaty with Germany provided that each jurisdiction would have freedom to deal with "'hybrid' financial instruments that have both debt and equity features," and stated that each country could apply its statutory withholding rate as long as they permit payments under the instrument to be deducted.[89]

The United States also has rules for specific entities built into its bilateral treaties.[90] For instance, certain Canadian instruments treated as partnerships (such as United States limited liability corporations under the federal code) are subject to a branch tax and are not entitled to certain treaty benefits if they are operating in Canada as a hybrid entity.[91]

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ten percent or more of the tax paying entity; (3) a related person under §§ 267(b) or 707(b); (4) any other person the secretary designates).

83. *See id.* at § 909.

84. *See* IRS, INTERNAL REVENUE BULLETIN 2010-92 916-23 (2010), https://www.irs.gov/pub/irs-irbs/irb10-52.pdf [hereinafter IRS BULLETIN] (discussing the applicability of Section 909 of the Internal Revenue Code to certain foreign taxes).

85. *See* 26 U.S.C. § 909; *see also* William P. Streng, *U.S. Tax Treaties: Trends, Issues, and Policies in 2006 and Beyond*, 59 SMU L. REV. 853, 874 (2006) (giving a more complete description of how a reverse hybrid structure could be used to achieve double non-taxation).

86. *See* IRS BULLETIN, *supra* note 84, at 919 (noting that these structures must contain three further elements: (1) a foreign debt instrument disregarded for U.S. purposes; (2) the instrument owner pays foreign tax attributable to said instrument; (3) the issuer receives a deduction for the foreign tax and suffers a shared loss, which is then taken into account by one or more "covered persons with respect to the owner of the instrument").

87. *See* IRS BULLETIN, *supra* note 84, at 919; *see also supra* note 81 and accompanying text. A hybrid instrument as defined could refer to a collateralized repo loan, mentioned earlier in this Comment. *See supra* note 34 and accompanying text. The United States wanted to stop these devices due to artificial credit generation allowing for excess repayment. *See supra* note 81 and accompanying text. Many nations continue to see such transactions as a sale, not a loan, which allows this credit generation to continue abroad. *See supra* note 81 and accompanying text.

88. *See, e.g.*, BLOOMBERG BNA, WORKSHEET 11 1989 GERMANY-UNITED STATES INCOME AND CAPITAL TAX TREATY 1 (1989) (discussing a bilateral treaty between Germany and the United States that focuses on mismatch issues).

89. *Id.* at 3.

90. *See infra* note 109 and accompanying text (identifying an example of specific rules for United States limited liability companies).

91. *See* TD Sec. LLC v. The Queen, [2010] C.T.C 186 (Can.); *see also* Income Tax Convention art. XIV, U.S. – Can., Sept. 26, 1980, T.I.A.S. No. 11,087; Thomas Kollruss et al.,

B. United Kingdom Legislation

The United Kingdom enacted specific rules to address hybrid mismatch arrangements as early as 2003.[92] These rules target different types of deduction schemes.[93] The rule only applies if four separate "avoidance scheme" conditions are met: 1) the transactions of the company are part of a "scheme that is a deduction scheme;" 2) the company has claimed or can claim a deduction or can offset an amount of the transaction against profits; 3) "the main purpose of the scheme, or one of its main purposes, is to achieve a U.K. tax advantage;" and 4) the tax advantage achieved is "more than minimal."[94] Pursuant to Section 233(1) of The Taxation (International and Other Provisions) Act, the legislation specifies in Sections 336–42 seven types of deduction schemes.[95] This legislation is activated when a Her Majesty's Revenue & Customs (HMRC) officer sends a notice to an infringing company; and unless a U.K. company can show a clear need for it, HMRC will generally scrutinize the scheme for tax avoidance.[96] Most legislation from other jurisdictions shares this theme of involving several "qualifying steps" or "schemes."[97]

The Taxation (International and Other Provisions) Act targets credit generation through a qualifying step approach. It states that a qualifying scheme must fall within at least one of five circumstances: 1) the foreign credit is supposed to be attributed to a different source from which income is derived; 2) the foreign taxpayer has not accounted for the full economic cost of said tax against the income for which they claim relief; 3) an election or option existed in another jurisdiction that would have reduced the credits given, instead of increasing the amount; 4) the credits given reduce the amount of tax payable to an amount lower than what would have been paid had the scheme not existed;

Canadian MNCs International Tax Planning: Treaty and Practice, 42 INTERTAX 276, 284-86 (2014) (providing an example of how firms might use this taxing principle); *see also* OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 17 n.14, 18 n.16.

92. James Ross, Bloomberg Tax and Accounting Center, *Host Country United Kingdom*, 35 TAX MGMT. INT'L FORUM, Dec. 2014, at 118, 119-20; *see also infra* note 93.

93. *See* Taxation (International and Other Provisions) Act 2010, c. 8, §§ 233–42 (U.K.).

94. *Id.* at § 233.

95. *See id.* at §§ 233(1), 236–42. The seven applicable schemes are: Schemes involving hybrid entities (§ 236); Instruments of alterable character (§ 237); Shares subject to conversion (§238), Securities subject to conversion (§ 239); Debt instruments treated as equity (§ 240); Schemes including issue of shares not conferring qualifying beneficial entitlement (§ 241); Schemes including transfer of rights under a security (§ 242). *Id.*

96. *Id.* at § 232; *see also* HER MAJESTY'S REVENUE & CUSTOMS, INTERNATIONAL MANUAL 59730, http://www.hmrc.gov.uk/manuals/intmanual/INTM597530.htm (last visited Jan. 11, 2016).

97. *See generally* OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17 at 15–22 (comparing and contrasting anti-hybrid rules in several different jurisdictions, including: Denmark, Germany, New Zealand, the United Kingdom, Italy, Austria, and the United States); Jakob Bundgaard, *Hybrid Financial Instruments and Primary EU Law–Part 1*, 53 EUR. TAX'N 539, 548 n.80 (2013). Recent German legislation has made it so that a company may not obtain a tax exemption "to the extent that the dividend is deductible in the state of the payor." *Id.* at 548.

and 5) a source of income, usually subject to a foreign tax, has been acquired as consideration for a tax deduction.[98] If these conditions are satisfied, HMRC will then deliver a notice that the legislation applies and the scheme is being rejected, or may give an opinion on how much credit will be allowed under the given scheme.[99]

IV. ANALYZING THE PROPOSED SOLUTIONS

A. The United States' Approach

Some observers have posited that the United States has implemented overreaching legislation to deal with hybrid mismatch arrangements.[100] However, tax revenue loss is a very real problem for the United States. For example, in 2011 alone, the United States lost an estimated $3.5 billion in eleven mismatch transactions.[101] In addition, many of the lowest tax paying multinational corporations are incorporated and headquartered in the United States.[102]

Apple has one of the lowest income tax rates among the international corporate community.[103] The company's lucrative tax structure relies on exploiting vulnerabilities in the U.S. tax code.[104] Apple has been able to create mismatch arrangements that are then exported to other jurisdictions.[105] Typically Apple then importes the maximum amount of foreign tax credit allowable back into the United States, while taking the deduction for the mismatch in the other jurisdictions.[106] This structure allowed Apple to avoid deduction restrictions under Section 1503 by using credits instead of deductions, but lowering its international liability at the same time.[107]

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98. OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 20-21.

99. *Id.* at 21.

100. *See* Andriy Krahmal, *International Hybrid Instruments: Jurisdiction Dependent Characterization*, 5 HOUS. BUS. & TAX L.J. 98, 100 (2005) ("Some commentators point out that check-the-box regulations, promulgated to improve the administrability of entity classification, reach too far by including foreign entities in their regulatory reach, thus creating additional opportunities for tax arbitrage.").

101. OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 5–6.

102. *See* Kiernan, *supra* note 2.

103. Kocieniewski, *supra* note 5.

104. *See id.*

105. *See id.*; Graaf, Hann & Wilde, *supra* note 1, at 312; OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 36; David Jolly, *O.E.C.D. Calls for Coordinated Fight Against Corporate Tax Avoidance*, N.Y. TIMES (Sept. 16, 2014), http://www.nytimes.com/2014/09/17/business/international/oecd-fights-corporate-tax-avoidance.html?_r=0 ("[T]he rules governing global tax affairs, created in the 1920s, can seem out of touch when a Google, Apple or Microsoft can move millions or billions of dollars of profit from one country to another at the click of a button.").

106. *Id.*

107. *See supra* note 105 and accompanying text. It is important to note that mismatch arrangement structures such as those implemented by Apple, though helpful for tax structuring, are

Apple is not the only American corporation using these structures.[108] In fact, a corporation or partnership need not be creative at all to create a mismatch arrangement under current standards and the "check-the-box" rules.[109] These regulations allow taxpayers to check off whether they want to be treated as a corporation or a transparent entity for tax purposes, which greatly increased the use of hybrid instruments in the United States.[110] For example, Canadian partnerships "checking the box" to be a corporation for U.S. tax purposes could use U.S. tower structures to fund acquisitions and receive a double deduction.[111]

B. The United Kingdom Approach

The U.K.'s qualifying step approach is common because (though seemingly complex at first glance) it actually makes it easier for the taxpayer to decipher what structures will fit into the legislation.[112]

In the case of hybrid mismatch arrangements, however, such an approach can create a double-edged sword. Having many qualifying steps could allow a company to more specifically tailor its instruments to fit inside the bounds of the code.[113] Also, a corporation can simply look for the most beneficial qualifiers for its desired arrangement in a different jurisdiction, thereby avoiding more stringent standards altogether.

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not the only instruments that reduce tax liability. *See, e.g.*, Katie Walsh, *Transfer Pricing Rules Core Issue In Apple Profit Shifting*, FIN. REV. (May 22, 2013) http://www.afr.com/p/technology/transfer_pricing_rules_core_issue_OvzcB7ybbCrkvwOTBkjEIN (discussing Apple's use of transfer pricing rules to obtain a tax advantage).

108. Krahmal, *supra* note 100, at 101 (commenting on the widespread use of hybrid instruments). See also Kiernan, *supra* note 2.

109. *See* Krahmal, *supra* note 100, at 100; KPMG, OECD TAKES AIM AT INTERNATIONAL HYBRID MISMATCH ARRANGEMENTS 3 (2014), https://www.kpmg.com/Ca/en/IssuesAndInsights/ArticlesPublications/TNF/Pages/tnfc1423.pdf.

110. Krahmal, *supra* note 100, at 100.

111. KPMG, OECD TAKES AIM AT INTERNATIONAL HYBRID MISMATCH ARRANGEMENTS, *supra* note 109, at 3. A "tower structure" works in the following manner:

> The lower level UK company pays interest on the loan to the top UK company. For UK purposes, the interest income is offset by the interest expense under normal group relief rules – so there is no net taxable income. For US purposes, the UK subsidiary is a disregarded entity, so its interest expense is taken as a deduction in the US parent and, through the US consolidated tax return, offset against trading profits in the US subsidiary. The UK company sandwiched in the US group is a hybrid entity, in that it is regarded as a company in the UK and as a branch in the US. The result is that two deductions are claimed for a single payment of interest.

Bill Dodwell, *Tumbling Tower*, TAXADVISOR (Apr. 20, 2014), http://www.taxadvisermagazine.com/article/tumbling-tower.

112. *See* Graaf, Hann & Wilde, *supra* note 1, at 312.

113. *See generally supra* Section III.B; Taxation (International and Other Provisions) Act 2010, c. 8, § 233 (U.K.).

Apple took full advantage of the U.K. tax structure, paying no U.K. income tax in 2012 and only one percent in 2013.[114] Apple was able to do this because it paid a very high percentage of its expenditure to itself through its subsidiaries in other countries.[115] A great deal of its U.K. profit was placed into special loans, which were given to subsidiary companies in Ireland through hybrid entity payments, allowing Apple to write off massive amounts of profit.[116]

C. The OECD Proposal, Trying to Change the Approach

The 2014 OECD proposal attempts to fix the problems caused by these mismatch arrangements through a series of recommended rules that vary between each hybrid mismatch structure.[117] The rules set out by the OECD are broad, imprecise, and attempt to solve the problem through vague recommendations.[118]

The proposal first discusses the rules for deduction/no inclusion schemes.[119] The OECD states these instruments should be neutralized "through the adoption of a linking rule that aligns the tax outcomes for the payer and payee under a financial instrument."[120] The payer should simply deny any deduction under such an arrangement, and if this does not work, then the payee jurisdiction should include it as ordinary income.[121] "Reasonable" timing differences in payment recognition under these arrangements will not be treated as giving rise

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114. *Apple Paid No UK Corporate Taxes in 2012: Report*, HUFFINGTON POST (July 1, 2013), http://www.huffingtonpost.com/2013/07/01/apple-uk-corporate-tax_n_3528372.html; Frankie Goodway, *Apple's UK Tax Avoidance In Two Numbers*, MIRROR (Sept. 29, 2014), http://www.mirror.co.uk/news/ampp3d/apples-uk-tax-avoidance-two-4344344 (explaining that by paying £11.4 million in corporate taxes on £100 million in revenue, Apple's "effective" U.K. tax rate was one percent).

115. *See* Goodway, *supra* note 114.

116. *See id.* This exemplifies the complexity and usefulness of these arrangements. It is important to note that Apple's UK tax structuring was not based entirely off of mismatch arrangements—transfer pricing has always played a large role in its profit shifting. *See* Walsh, *supra* note 107. In addition, due to special VAT taxes in Europe, Apple pays no taxes at all on money raised from iTunes in the UK; those funds go directly to Luxembourg. *See* Tim Worstall, *Apple Dodges All Taxes In The UK—Again*, FORBES (July 1, 2013), http://www.forbes.com/sites/timworstall/2013/07/01/apple-dodges-all-taxes-in-the-uk-again/.

117. *See, e.g.*, OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 59–61 (recommending rules for arrangements that produce indirect deductions/no income).

118. For instance, one U.S. Treasury Department official stated that while the U.S. "is pleased with the final reports," another stated that the U.S. is "concerned that the work did not go further" and "concerned that the standards adopted are too vague and will lead to increased tax disputes." *Now it's Up to the Nations: OECD Delivers Global Tax Plan*, BLOOMBERG BNA (Oct. 6, 2015), http://www.bna.com/nations-oecd-delivers-n57982059152/*; see also infra* Sections IV.C.2–5.

119. OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 59–61.

120. *Id.* at 36.

121. *Id.* at 37.

to a deduction/no inclusion scheme.[122] The recommendation goes on to state that this rule only applies to instruments entered into with a "related party" and will not apply at all where the instrument is used "to preserve tax neutrality for the payer and payee."[123]

The OECD proposes the same plan for double deduction schemes, neutralizing mismatch arrangements through linking rules that align tax outcomes.[124] However, the double deduction rule only applies where the mismatch parties are in the same "control group . . . or structured arrangement."[125]

The report finally recommends a rule for indirect deduction/no inclusion structures.[126] The report proposes vaguely that every jurisdiction should implement a linking rule denying deductions for a payment made under an imported mismatch.[127] The rule will only apply to payments that are offset against a deduction in the imported mismatch, and only if the parties are once again, in the same "control group" or "structured arrangement."[128]

1. Proposals to Neutralize Hybrid Mismatches

In its public discussion draft of the BEPS action plan, the OECD proposed two separate approaches for implementing these recommended rules: the "bottom-up" and "top-down" approach.[129] A "bottom-up" approach seeks to identify structures that involve the most pressing issues for tax policy.[130] This includes "related parties" and instruments as part of a structured mismatch design.[131] The OECD believes this will result in a more focused approach for the implementation of the proposal.[132] This approach will take a significant

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122. *Id.* at 36.
123. *Id.* at 36, 38.
124. *Id.* at 52.
125. *Id.*
126. *Id.* at 60.
127. *Id.* at 60–61.
128. *Id.* at 52.
129. *See* OECD, BEPS ACTION 2, *supra* note 8, at 33.
130. *Id.*; *see also* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 67. The deliverable BEPS action plan narrowed the focus to only a bottom-up approach, which includes financial instruments held by related parties or held by parties within the same structured arrangement. A structured arrangement "is 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." OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 67. Two persons are defined as related persons "if they are in the same control group or the first person has a 25% or greater investment in the second person." Id. at 69.
131. OECD, BEPS ACTION 2, *supra* note 8, at 33.
132. *Id.*

period of time. It would require going through every transaction to identify whether it is a mismatch arrangement or not for the corporation involved.[133]

The "top-down" approach will work much differently.[134] This approach would start with a rule encompassing all hybrid instruments, unless excepted under narrow criteria, making compliance difficult for taxpayers.[135] This approach would catch many more arrangements in its scope, but would allow for "different carve outs for different taxpayers in respect of those different instruments."[136] The OECD states this approach will be more "comprehensive" because only arrangements that clearly need to be excluded will be.[137] This approach will have one broad overarching rule that will catch all arrangements unless they can fall into an exception.[138]

2. Definition Issues

International acceptance of definitions is a constant issue, and small deviations can cause large problems when it comes to tax treaties and conventions.[139] Definitional issues exist even within the proposed OECD model.[140]

The proposal presents broad definitions of other topics, which decreases the likelihood of implementation because of overly extensive coverage.[141] Perhaps the biggest issue is with the definition of "related parties," regardless of the jurisdiction's implemented approach.[142] Several groups have pointed out that a holder of a financial instrument who is considered a "related" party with as little

133. *Id.*

134. *Id.*

135. *Id.* (these limited exceptions are not defined further in the proposal).

136. *Id.*

137. *Id.*

138. *Id.*

139. *See, e.g.*, Sven-Eric Bärsch, *The Definitions of Dividends and Interest Contained in the OECD Model, Actual Tax Treaties, and the German Model*, 42 INTERTAX 433, 440 (2014). This article provides examples of the OECD model tax treaty definitions of terms such as dividend and interest. *Id.* at 434–37. In the case of Germany, for example, most tax treaties and domestic laws deviate from the OECD's exact model and wording, allowing instruments such as hybrid arrangements to thrive because small changes lead to different treatment. *Id.* at 440. Only the German model has come close to solving this issue, but it is still not capable of providing "legal certainty" and does not tackle the issue of mismatch arrangements fully. *Id.* at 443.

140. *See id.* at 434–37, 443.

141. *See* Letter from Will Morris, Chair, BIAC Tax Committee, to Achim Pross, Head, International Co-operation and Tax Administration Division, Centre for Tax Policy Administration, OECD (May 2, 2014), *in* OECD, COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFTS: BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS 80–81 (2014), http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf (stating the definitions of "hybrid instrument" and "ordinary income" are so broad that they go beyond what the 2014 OECD proposal is intended to accomplish).

142. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 67, 69.

as ten percent ownership of its equity may potentially be subject to action under the proposed rules.[143] This raises a concern that such an ownership threshold is too low and encompasses commercial transactions that present no risk of a hybrid mismatch.[144] This is especially pertinent for banks, which would have to spend large portions of time monitoring transactions and parties to those transactions in order to account for mismatches that run afoul of new regulations.[145]

3. Issues With OECD Recommended Rules

This Comment has previously discussed the OECD recommended rules.[146] These are rules the OECD expects countries to implement and abide by, but upon close analysis, the rules themselves have several problems.[147]

In each set of recommended rules, the OECD proposes "linking rules," and in a case where the main rule fails or is not used, the "defensive rule" will activate.[148] The OECD, however, finds "linking" and "defensive" rules to be

143. ERNST & YOUNG GLOBAL LTD.: BEPS ACTION POINT 2 ON HYBRID MISMATCH ARRANGEMENTS, *supra* note 21, at 3. Further proposals suggested amounts as high as twenty-five percent. These related parties could be an investor in the company, a holder of company stock, or other securities holders. For instance, under the OECD proposal, a stock holder in Ford who controls ten percent of their stock would be expected to know all of the companies' tax transactions that could be affected by the proposal. This puts a huge burden on the investor, while also diminishing the investor's will to continue their investment strategies. *See generally* Letter from Richard Middleton, Managing Director, Tax and Accounting Policy, AFME, & Sarah Wulff-Cochrane, Director of Policy, BBA, to OECD (May 2, 2014) *in* OECD, COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFTS: BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS 7 (2014), http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf.

144. *See id.* (stating that at least a fifty percent interest in a transaction is appropriate to be subject to hybrid mismatch rules because at this level, one would have sufficient knowledge of the tax structure and lower the risk of catching non-tax related issues); Letter from WJ Dodwell, Deloitte LLP, to Dr. Achim Pross, Head, International Co-operation and Tax Administration Division, OECD/CTPA (May 2, 2014), *in* OECD, COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFTS: BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS 160 (2014), http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf (concurring with a fifty percent ownership threshold); Letter from Paul Hale, Director, Head of Tax Affairs, Alternative Investment Management Association, to Achim Pross, Head, International Co-operation and Tax Administration Division, OECD (May 1, 2014) *in* OECD, COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFTS: BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS 3-4 (2014), http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf.

145. ERNST & YOUNG GLOBAL LTD.: BEPS ACTION POINT 2 ON HYBRID MISMATCH ARRANGEMENTS, *supra* note 21, at 3.

146. *See supra* Section III.C.

147. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 63–65.

148. *Id.* at 12.

nearly identical for each type of arrangement.[149] For example, the rule for applying payment under a financial instrument that results in a hybrid mismatch is supposed to deny the deduction. If this does not work, then the payer should include the instrument as regular income. Similarly, the rule for payments that produce double deduction outcomes, would first deny the deduction in the parent jurisdiction and then, as a defensive rule, deny the deduction in the payer jurisdiction.[150] The mismatch rules sound simple enough, but they are far from perfect.

One serious problem related to mismatch arrangements is a lack of knowledge as to which nation is gaining and losing tax revenue.[151] Undoubtedly, it is difficult to know when and where to apply the rule properly.[152] A nation must first identify the mismatch arrangement, then ensure it is used for an aggressive tax planning purpose, and, finally, it must properly implement the rules set forth by the OECD.[153] Even if this was all accomplished, the proposal would be difficult to coordinate and implement. The OECD already acknowledged that it runs the risk of causing double taxation because jurisdictional authorities can easily become confused by the exact details of an arrangement.[154] If the implementation of a rule is not administered in a clear and efficient manner, the rule can potentially activate double taxation.[155]

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149. *See generally id.* at 33, 37, 51, 53, 59, 61 (subjecting different types of financial instruments to pairs of linking and defensive rules).

150. *Id.* at 37, 53.

151. *See* OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 11 ("[I]t is often difficult to determine which of the countries involved has lost tax revenue," although "it is clear that collectively the countries concerned lose tax revenue.").

152. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 63. The OECD proposal states that "[j]urisdictions and taxpayers applying the rules will need to understand how a financial instrument or entity is treated in another jurisdiction . . . [and] whether or not hybrid rules are in operation in a counterparty jurisdiction." *Id.* This will necessitate "work . . . to share information between jurisdictions and with taxpayers." *Id.*

153. *See generally id.* at 63–64 (discussing the complexities of identifying hybrid mismatch arrangements and their tax consequences, and the coordination between jurisdictions that will need to occur in order for the OECD proposal to work).

154. *See id.* at 12 (stating that the risk of double taxation is a main impetus of having both primary and defensive rules). According to one report, "[t]ax practitioners have said they anticipate more aggressive audits around the world as countries implement the OECD's recommendations—and a huge increase in double tax disputes as a result"). BLOOMBERG BNA, *supra* note 118.

155. *See* DELOITTE U.K., BEPS ACTION 2: HYBRID MISMATCH ARRANGEMENTS (2014), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-uk-beps-action-2.pdf (expressing concern over "unilateral measures that may result in double taxation"); Letter from Catherine Schultz, Vice President for Tax Policy, Nat'l Foreign Trade Council, to Achim Pross, Head, International Co-operation and Tax Administration Division, OECD (May 1, 2014), http://www.nftc.org/default/tax/Comments%20on%20OECD%20Hybrid%20Mismatch%205-1-14.pdf (stating that it will be "difficult for policymakers to determine the extent to which to adopt the rules, producing variations across jurisdictions and creating even more complexity" and that the rules leave open the possibility of double taxation). *See generally* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 60 (commenting on the need for further clarification of the proposed rules to avert double taxation).

Along the same lines, transactions could arise between countries that have implemented these rules and countries that have not.[156] The OECD continuously states that the goal and best way for the rules to work is for all nations to implement all of its rules, which this Comment addresses as a near impossibility.[157] Imagine a situation where there is a jurisdictional mismatch and one nation has the OECD rules in place, while the other nation has its own national legislation in place.[158] It is unclear which rule to use, and which outcome makes the OECD rules useless or causes more problems.[159]

It is important to note that not all of the rules the OECD wants to implement are problematic. Some are beneficial and should be implemented regardless of the medium that they use to stop hybrid mismatch arrangements.[160] For instance, the OECD wants to limit the amount of useable credit from hybrid financial instruments and loans to decrease tax erosion.[161] Additionally, the 2014 proposal aims to implement rules from past proposals in order to ensure that existing tax regulations are in accordance with mismatch rules.[162]

4. Compliance Issues With Full Scale Implementation

The largest analytical issue that has stemmed from the OECD proposal is the issue of compliance and expectation that countries will implement the proposal

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156. *See generally* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 12 (discussing the need for defensive rules, which apply " where there is no hybrid mismatch rule in the other jurisdiction").

157. *See id.* at 60 ("The most reliable protection against imported mismatches will be for all jurisdictions to introduce rules . . . .").

158. *Id.* at 63. As one accounting firm warned,

> The high level of complexity creates a significant risk that the Action 2 recommendations will prove too difficult to administer in practice, for both tax authorities and taxpayers. This risk is likely to be exacerbated to the extent that jurisdictions fail to coordinate multilaterally as the OECD intends. Divergent and uncoordinated domestic rules enacted by various jurisdictions will create substantial compliance burdens for taxpayers and potential confusion among jurisdictions[.]

PRICEWATERHOUSECOOPER, PWC'S COMMENTS ON ACTION 2, 10 (2014), https://www.pwc.com/gx/en/tax/tax-policy-administration/beps/assets/hybrids-mismatches-may-2014.pdf.

159. *See supra* note 155 and accompanying text; *see also* MICHAEL CADESKY, THE U.S. VIEW ON BEPS 15 (2014), http://publications.ruchelaw.com/pdfs/2014-10/US_View_On_BEPS_AOTCA.pdf (arguing, in a paper presented at the 2014 Asia-Oceanic Tax Association Conference, "[w]hile the goals [of a top-down approach] are specific, the remedy is vague and application of vague remedies in different countries can easily result in multiple adjustments that reach conflicting results—all countries involved in the cross border transaction assert primary jurisdiction to impose tax."); *BEPs Project Almost Completed: An Overview of the 2015 OECD Deliverables*, BDO (Sept. 25, 2015), http://www.bdo.be/en/news/professional-news/2015/beps-sept-2015/ ("[M]any interpretation issues remain and conflicting views between OECD Member States and developing countries are likely to result in tax controversy.").

160. *See* OECD, NEUTRALIZING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 33–36.

161. *See id.*

162. *See id.* at 64–65.

in its entirety.[163] Nations may try to comply, but the sheer complexities of the proposal and tax structures will make compliance difficult.[164] Nations will inevitably interpret legislation differently, which may lead to unexpected compliance burdens.[165]

A nation's sovereignty and desire to compete on a world stage presents an additional issue.[166] These arrangements stem in part from a need to compete in the global economy and countries are unlikely to implement legislation or treaties that make them less competitive.[167] Currently, the strongest support for the OECD proposal comes from the European Commission, but if the EU attempts to adopt the proposal wholesale, it may face backlash from member states.[168]

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163. *See* Letter from Alex Postma to International Cooperation and Tax Administration Division, Centre for Tax Policy and Administration, OECD (May 2, 2014) (on file with LexisNexis).

164. *See* Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV 79, 161, 162 (2002) (explaining how coordination between countries when adopting rules to address hybrid arrangements could result in remaining unanswered questions); *see also* Letter from Krister Anderssen, Head, Tax Policy Department, Confederation of Swedish Enterprise, to OECD Centre on Tax Policy Administration (Apr. 29, 2014) (on file with LexisNexis) (illustrating that it is often very difficult for countries to determine who is losing out on a tax benefit and who is not in a hybrid arrangement — full implementation would still leave a mountain of issues regarding compliance logistics and identifying proper structures.); Arjo van Eijsden, *The Relationship Between Corporate Responsibility and Tax: Unknown and Unloved,* 22 EC TAX REV. 60, 64 (2013) (stating that mismatch arrangements that fully comply with the law pose a major issue and achieve the undesireable double non-taxation in two jurisdictions). Implementing overly broad policies to stop a practice, when the regulations that are causing it are unknown, can create even more confusion in the long run. *Id.*

165. *See* Letter from Ivo Tenten and Meera Patel, BASF SE, to Achim Pross, Head, International Co-Operation and Tax Administration Division, OECD/CTPA (May 2, 2014), *in* OECD, COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFTS: BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS 60–63 (2014), http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf (suggesting that the only way the OECD proposal could prevail is for every nation to adopt exactly the same rules and regulations, and then have all of those jurisdictions interpret them exactly the same). Not only is this unlikely to happen, some nations have no reason or intention to comply because they benefit from aggressive tax structuring. *See id.*

166. *See id.* (stating that "it is not the role of the OECD to provide guidance to countries to change their domestic legislation," the recommendations "conflict with the sovereignty of nations on national taxation," and that countries are unlikely "to give up their sovereignty, especially not in cases where local incentives are intended").

167. *See id.* (explaining that countries use different taxation policies and systems to achieve economic growth, resulting in tax competition).

168. *See* Peter Kavelaars, *EU and OECD: Fighting against Tax Avoidance*, 41 INTERTAX 507, 510 (2013) (stating that the EU wants to implement its own legislation on "parent-subsidiary directives," which is designed to target hybrid loans and other hybrid instruments to prevent non-tax situations); *see also EY EU Watch*, 25 J. INT'L TAX'N 20, 20 (2014) (stating that the European Commission supports the OECD's proposed rule that "the recipient country could refuse to grant an exemption if the payor is able to obtain a tax deduction").

5. Treaty Issues and Intra-Country Agreements

The OECD proposal is overly ambitious and fails to account for many aspects of current tax laws and many commonly used financial instruments.[169] Given the various treatments that mismatch arrangements face around the world,[170] it is no wonder why corporations "treaty shop" for countries with the most favorable tax treatment, and why so many treaties have failed to effectively restrain hybrid mismatch arrangements.[171]

Some countries, such as the United Kingdom, have made significant efforts to curtail hybrid mismatch arrangements, while others, such as Ireland, continue to permit aggressive tax structuring.[172] Given this stark contrast in tax treatment, why would a company ever choose to go to a jurisdiction with more stringent tax rules? Why not take advantage of every treaty possible when nations like the United States are implementing legislation that has exacerbated the use of hybrids and promoted more aggressive tax planning?[173] Why would nations like Ireland ever choose to implement the OECD's broad proposal when they know that they only stand to lose in the long-term and become less attractive to corporations?[174]

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169. *See* Michael L. Schler, *BEPS Action 2: Ending Mismatches on Hybrid Instruments, Part 2*, TAX NOTES TODAY, Aug. 19, 2014, 2014 TNT 160-6 (LexisNexis) (explaining that since the draft provides only an outline of the principles, countries will be more likely to adopt conflicting legislation rather than the uniform system that is sought by the OECD, and that the proposal fails to account for many common financial entities, such as regulated investment companies in the U.S. and controlled foreign corporations).

170. *See supra* Parts II–III.

171. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 4, 23–25 (discussing that the recommendations were generated as a result of concerns raised by countries experiencing mismatch arrangements and were designed to prevent treaty abuse); *see also* OECD, REVISED DISCUSSION DRAFT: FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE 6 (2014–2015), http://www.oecd.org/tax/treaties/discussion-draft-action-6-follow-up-prevent-treaty-abuse.pdf [hereinafter OECD, FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE] (providing an example to demonstrate that the benefits conferred by different treaties produce treaty shopping because one country would confer more favorable tax treatment upon a pension fund than another).

172. OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 15 nn. 6–7, 17 n.14, 18 nn.16–17; Darby & Lemaster, *supra* note 56, at 2, 12, 14; Kleinbard, *supra* note 59, at 733; Stephen C. Loomis, *The Double Irish Sandwich: Reforming Overseas Tax Havens*, 43 ST. MARY'S L.J. 825, 836–39 (2014).

173. *See, e.g.*, 26 U.S.C. § 894(c)(1) (2012) (prohibiting reduced rates for withholding taxes in cases where there is an income tax treaty with a foreign country).

174. *See supra* notes 163–65 and accompanying text (discussing national sovereignty and the desire to maintain a competitive corporate tax regime); *see also* Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 21 (1993) ("As long as multinationals have the ability to shift the reported source of their income, governments imposing source-based corporate income taxes will have an incentive to compete for this shiftable income."). In a similar fashion, "[t]he current U.S. corporate income tax rate of 35% is the highest in the OECD, and that does not serve the country well—the greater the difference between the U.S. and foreign corporate tax rates, the greater the incentives for shifting income

The OECD has attempted to address such issues with further legislation and a change to its model tax convention, but this approach is equally unlikely to succeed because it has already been shown that deviations from the OECD convention can lead to problems with definitions and implementation.[175]

V. CHANGING THE FOCUS: A BI-LATERAL TREATY APPROACH

Apple's tax structure illustrates the current flaws with the world's approach to hybrid mismatch arrangements.[176] Year after year, Apple generates some of the highest revenue of any corporation in the world while paying some of the lowest taxes.[177] Using reverse hybrids, hybrid financial instruments in the United States, hybrid entity payments in the United Kingdom, and importing mismatches from several other nations, Apple legally reduced its tax burden all over the world.[178] Why then should the answer to mismatch arrangements be further domestic legislation, which countries will not uniformally agree on and multinational corporations will circumvent?

This approach from the OECD will likely fail given that similar approaches have also failed in other aspects of international taxation.[179] The OECD must realize that nations are unlikely to implement sweeping tax legislation proposals on a domestic level.[180] Variables such as sovereignty, international competition, and differing opinion will likely stymie implementation, which, in turn, will lead

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abroad." Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 428 (2013).

175. *See OECD Action 2*, *supra* note 8, at 13 (stating that "[t]he rules must be the same in each jurisdiction" with "jurisdiction neutral definitions"); *see also* OECD, FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE, *supra* note 168, at 9–13 (discussing all the changes that should be made to the OECD model tax treaty, including definitional issues).

176. *See supra* notes 112–14 and accompanying text.

177. *See supra* notes 1–3 and accompanying text.

178. *See supra* text accompanying notes 103–07, 112-14.

179. For example, with regard to transfer pricing, much like with hybrid mismatch arrangements, the OECD proposed "ideal" transfer pricing guidelines that it wanted every nation to implement. *Compare* OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 59–60 (2010), http://dx.doi.org/10.1787/tpg-2010-en (explaining situations where transaction profit methods and traditional transaction methods would be more suitable for one country than another country), *with Australia Introduces Multinational Anti-Avoidance Legislation*, 26 J. INT'L TAX'N 17, 21 (2015) (noting that the Netherlands conforms to the OECD guidelines); OECD, TRANSFER PRICING COUNTRY PROFILES: UNITED KINGDOM (2013), http://www.oecd.org/ctp/transfer-pricing/transferpricingcountryprofiles.htm (showing that as of September 2012, the United Kingdom had made reference to the OECD Transfer Pricing Guidelines and included a definition in their tax code, but it had not instituted transfer pricing methods or set specific penalties for transfer pricing). *See generally* OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010), http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm (outlining transfer pricing guidelines). While some nations implemented the guidelines, others did not adopt them as laid out, if at all.

180. *See supra* Section IV.C.

to treaty shopping.[181] The OECD must focus its approach on proposed changes to bilateral treaties instead of significant changes to domestic laws, which would allow nations to bargain for some leeway while creating the desired regulatory effect.

In its current report, the OECD discusses treaties and proposes that nations implement the entire OECD model tax convention in addition to the other rules they are encouraging.[182] If such a proposal took effect, it would represent a major overhaul of the international tax scheme.[183] Every nation would be on the same footing, using the same documents, and realizing the tax structure of each individual nation. While implementing this approach would be much easier, the reality of each nation actually doing this is highly unlikely.[184]

This Comment suggests that a proposal focused on promoting and changing bilateral treaties between nations instead of suggesting sweeping international tax law conversion will be more likely to yield better results for several reasons. First, the proposal would only position the OECD in an intermediary role. Instead of appearing to force sweeping changes upon countries, the organization will have greater international appeal, which will improve the likelihood of the proposal's implementation. Next, bilaterial treaties give sovereign nations the ability to implement tax rules that commensurate with their unique circumstances and characteristics, allowing them to more easily address the issue of double taxaton. Finally, bilateral treaties will make complicated mismatch arrangement transactions easier to track, and will allow countries to come to a solution instead of forcing independent legislative change.

Some treaties have already successfully targeted these arrangements, but corporations continue to treaty-shop[185] around this approach because it is often not specific enough to preexisting arrangements.[186] Efforts to combat this problem can be seen to some extent in existing tax legislation. Denmark, for

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181. *See supra* Section IV.C.5.

182. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 11, 18–19.

183. *See generally id.* (alluding to the extensive changes that would need to be made in order for the proposal to be effectuated as the OECD envisions it).

184. *See* Sections IV.C.4–5.

185. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 15, 40–41. Companies can currently use the nations where treaties are most beneficial to them, and because most treaties do not discuss payments made under mismatch arrangements, it is easy for companies to find a beneficial treaty. Under this approach, however, it is easier to implement rules that will cut down on treaty hunting by simplifying the treaty process to only two nations at a time. *See id.*

186. *See, e.g.*, Income Tax Convention art. XIV, U.S. – Can., Sept. 26, 1980, T.I.A.S. No. 11,087. The treaty states:

> Income derived by an individual who is a resident of a Contracting State in respect of independent personal services may be taxed in that State. Such income may also be taxed in the other Contracting State if the individual has or had a fixed base regularly available to him in that other State but only to the extent that the income is attributable to the fixed base.

Id.

example, places contingencies on certain provisions that apply to nations with which they have a treaty.[187] Such provisions would need to be expanded and placed within these hybrid-specific treaties, so that specific instruments are covered by the different nations.[188]

Drawing inspiration from the OECD report, the nations would need an inclusion rate for related parties, which would provide guidance on how much of a stake a given party needs in a transaction to be subject to the treaty.[189] Such an agreement must be reached to prevent the overinclusion of instruments, which is a major problem with the current proposal.[190]

The OECD report also proposes some rules that will be useful for implementation into these bilateral treaties.[191] For instance, the OECD recommends limiting the amount of credit that can be used in connection with hybrid financial instruments, such as collateralized "repo" loans.[192] The United States has already implemented similar legislation domestically and has entered into bilateral treaties to limit the use of foreign tax credits.[193] Because jurisdictions view current tax rules in different ways, limiting such instruments is of the utmost importance to limit tax erosion.[194] It would be far more feasible for countries to implement these rules through treaties, rather than for each country to change its domestic law, in concert.[195]

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187. *See* OECD, TAX POLICY AND COMPLIANCE ISSUES, *supra* note 17, at 17.

188. *See, e.g.*, *id.* The report discusses Section 2A of the Danish Corporate Tax Act and how Denmark's tax law prevents corporations from deducting "payments that are not taxable at the level of the recipient due to a mismatch in treatment." *Id.*; *see also* Ross, *supra* note 92, at 119 (discussing how, historically, companies were determined to be maintaining a "profit-earning trade" in the United Kingdom on the basis of where contracting occurs, and how even "profits attributable" to international telegraph messages could be taxed on that basis).

189. *See* OECD, BEPS ACTION 2, *supra* note 8. *But see* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 18.

190. *See, e.g.*, Deloitte U.K., *supra* note 152 (stating that under the current OECD proposal the banking and insurance industries will suffer under the new rules).

191. *See infra* note 191 and accompanying text.

192. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 40–41.

193. *See supra* note 88.

194. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 40–41.

195. To analogize from the example of double-taxation treaties, one commentator, while criticizing such treaties, notes benefits of "reciprocity," as well as "more compatible tax laws, improved collection of revenues, assistance in fighting tax avoidance, mutual supply of information, reduced bureaucratic burden for taxpayers, increased investor certainty, and improved foreign relations." *See generally* Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L L. & POL. 939, 987–88 (2000) (discussing the benefits of double taxation treaties). And, "[b]ecause the costs of not having access to treaty benefits can be significant, treaties provide an incentive for nations to standardize their tax systems." Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 145 (2009).

Finally, countries that are parties to a treaty could devise precise provisions that narrowly target hybrid mismatch arrangements.[196] The resulting instrument will be a document that presents a tailored approach to hybrids, neutralizing mismatches between two nations without the collateral dangers of overinclusion that are present in the OECD proposal.[197] The OECD hints at such an approach at the end of its proposal, but only with regard to the model tax convention.[198] If the OECD and each constituent jurisdiction can focus on these pointed treaties instead of a broad convention, the international community will come closer to neutralizing the ill effects of mismatches.

VI. CONCLUSION

This Comment seeks to provide meaningful insight into the history and use of hybrid mismatch arrangements and critique the new OECD proposal to stem their adverse effects for revenue collection. The proposal is far from perfect and there is much work to be done to accomplish the goal of neutralizing these arrangements. A directive that countries enact sweeping changes in their domestic laws will not effectuate this goal. As stated above, not only is it extremely ambitious to believe that all countries will suddenly change their domestic laws to match the new proposal, it is strange to think each country would interpret the proposal and the issues it raises in exactly the same way.[199]

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196. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGMENTS, *supra* note 12, at 23–25.

The OECD's 1999 report, titled "*The Application of the OECD Model Tax Convention to Partnerships*", and their 2010 report, titled "*The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*", each conclude that countries should "seek to ensure that the provisions of tax treaties produce appropriate results when applied to partnerships and [collective investment vehicles]." *Id.* at 24. The OECD has also outlined suggestions for domestic law and treaties "to ensure that hybrid instruments are not used to obtain undue treaty benefits." *Id.* at 25. This is the most complicated step of the treaty process because each nation will have to analyze the other countries domestic laws to find loopholes. For instance, a treaty between Canada and the United States would explicitly need to target instruments such as "tower structures" and certain payments from Canadian Unlimited Liability Corporations to U.S. parent companies, which have become popular mismatch instruments since the infamous "check the box" legislation. *See id.*

197. *See supra* note 195.

198. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, *supra* note 12, at 79–80. The proposal states that jurisdictions should pay close attention to disputes that arise between domestic law changes and the OECD model tax convention because treaty issues may arise. *Id.* The only opinion the OECD gives on bilateral treaties states that most of the tax treaties already in place do not affect payments, the purpose of the OECD proposal. *Id.* It further states that only domestic law can change the way payments are regarded, a statement that seems overly narrow in scope; the fact that current treaties cannot tackle the issue should not mean that future ones cannot. *Id.*

199. *See* Letter from Alex Postma to International Cooperation and Tax Administration Division, Centre for Tax Policy and Administration, OECD (May 2, 2014) (on file with LexisNexis).

In practice, a complete overhaul in domestic law is unlikely to happen and will not solve the problems that mismatch arrangements present.

Truly tackling these arrangements will require changes to bilateral treaties. Such an approach will require more groundwork on the part of each individual nation but will prove more beneficial in the long run. The OECD approach has underestimated the complexities of its proposal and the vast scale on which it seeks to effectuate change.[200] Its directives must be changed and a new approach must be taken if these arrangements are to be neutralized for the long term.

200. *See id.*