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Preventing Tax arbitrage via Hybrid Mismatches: BEPS Action 2 and Developing Countries*

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Abstract: *The Organization for Economic Cooperation and Development (OECD) under Base Erosion and Profit Shifting (BEPS) Action 2 indicated that tax arbitrage via hybrid mismatch arrangements “result in a substantial erosion of the taxable bases of the countries concerned” and “have an overall negative impact on competition, efficiency, transparency and fairness.” The relevant action allowing for neutralising the effects of hybrid mismatch arrangements is therefore needed and justified. To achieve that purpose, the OECD developed different anti-hybrid rules under BEPS Action 2. In that regard, however, one may ask whether addressing tax arbitrage via hybrid mismatches as proposed by the OECD is of interest and relevance for developing countries. This paper aims to map that unexplored research area by means of a comparative analysis in four developing countries – Uruguay, Colombia, Brazil, and South Africa.*

1 Introduction

Corporate taxpayers have access to a variety of international tax avoidance methods allowing them to avoid or significantly reduce their tax burden.¹⁰ Tax arbitrage via the use of hybrid mismatches is one such method. Given its characteristics, it is predominantly used by multinational enterprises (MNEs), since they conduct international business in an increasingly integrated way, combining technology, production, marketing, and a diversity of related tangible and intangible services across states.¹¹ Such multi-state integration facilitates the use of hybrid mismatches by MNEs to reduce the MNEs overall tax liability. This is, at the extreme, limited only by their financial capacity and managerial ingenuity.

*This paper condenses and articulates the findings set forth by several academic institutions involved in the DeStAt Research Project (Sustainable Tax Governance in Developing Countries through Global Tax Transparency) as the “South Antennae” on the basis of questionnaires drafted by the “North Research Units” of the same Project. Funding for the Project is provided by the Research Council of Norway. Further information about the Project can be retrieved on the following website: <http://www.jus.uio.no/ior/english/research/projects/global-tax-transparency/>. The study undertaken in this paper is based on the analysis of answers to the questionnaires (the questionnaires were prepared by Alessandro Turina and Thomas Dubut) submitted by the South Antennas. The Heads of the South Antennas include Addy Mazz (Uruguay), Natalia Quiñones (Colombia), Luís Eduardo Schoueri (Brazil), Jennifer Roeleveld (South Africa). Questionnaires on topics agreed by all institutions party to the project are drafted (primarily by the North Research Units and submitted to the South Antennae). Questionnaires are addressed through local seminars which aim at engaging all potential relevant stakeholders. Questionnaires encompass a legal-descriptive function as well as a more policy-oriented dimension. The questionnaires intend to highlight convergences and divergences between the selected pool of jurisdictions. Convergences and divergences are monitored in relation to both specific challenges/needs and to potential solutions. Questionnaires have incorporated survey sections, aimed at providing an accurate representation of the current state of affairs together with more policy-oriented sections.

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¹⁰ See more widely R. Russo, C.J. Finnerty, P. Merks, M. Petriccione, *Fundamentals of international tax planning*, (R. Russo ed., IBFD 2009); R. Langston, *Tolley's International Tax Planning: 2011-12*, London: (LexisNexis 2011).

¹¹ See OECD, *Addressing Base Erosion and Profit Shifting*, (OECD, 2013), International Organizations' Documentation IBFD at p. 25.

The Organization for Economic Cooperation and Development (OECD) under Base Erosion and Profit Shifting (BEPS) Action 2 stated that tax arbitrage via hybrid mismatch arrangements “result in a substantial erosion of the taxable bases of the countries concerned” and “have an overall negative impact on competition, efficiency, transparency and fairness.”¹² In that regard one may ask whether or not tax arbitrage via hybrid mismatches has a particularly distortive impact on the economy of developing countries. If there is a particularly distortive effect, then developing countries include addressing the problem of tax arbitrage by means of hybrid mismatches deterrents on the tax policy agenda. Both over- and under-reaction to this phenomenon is not desirable.

The purpose of this paper is to firstly to map by means of a comparative case study whether tax arbitrage via hybrid mismatches is recognized as a problem in four developing countries – Uruguay, Colombia, Brazil, and South Africa – and, if so, whether the tax arbitrage problem is addressed by these states. Secondly, if addressed, the current solutions, including legislative plans, are mapped. Thirdly, the approaches taken by the countries surveyed are compared against the recommendations of the OECD under BEPS Action 2 from which conclusions will be drawn as to the fit of these recommendations with the current measures adopted in these countries. This comparative research contributes to the DeSTaT Research Project, which, from the perspective of this paper, focuses upon increasing sustainable tax governance in developing countries through global tax transparency by means of providing the background information necessary for (i) developing a well-functioning system of exchange of information required for building the knowledge of tax authorities regarding tax arbitrage via hybrid mismatches; (ii) balancing the burden of proof between tax authorities and taxpayers related to the application of the proposed BEPS anti-hybrid rules; and (iii) providing a sufficient degree of practicability for taxpayers in applying proposed anti-hybrid rules.

From the comparison of actions taken by the stated countries and with respect to BEPS Action 2, policy recommendations for dealing with tax arbitrage via hybrid mismatches will be provided for these four developing countries. These policy recommendations may be equally beneficial to other developing countries.

To achieve the above aims, and following this introduction, the paper is structured as follows: section 2. provides the introduction to tax arbitrage via hybrid mismatches within the framework of BEPS Action 2. In section 3. the comparative analysis of selected issues regarding tax arbitrage via hybrid mismatches in the surveyed developing countries is undertaken. Finally, section 4. aims to answer (i) whether the surveyed developing countries recognize tax arbitrage via hybrid mismatches; (ii) if so, whether such mismatch situations are addressed by them; and (iii) if so, how such mismatches are addressed. Section 4 also contains tax policy recommendations for the selected developing countries. The recommendations aim at enhancing sustainable tax governance through global tax transparency in these countries, but may also be of relevance in a wider context.

¹² See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – Final Report*, (OECD 2015), p. 11, International Organizations' Documentation IBFD.

2 Preventing tax arbitrage via hybrid mismatches: general overview with specific reference to BEPS Action

2.1 Origin of tax arbitrage: tax optimization vs tax avoidance

The notion of “tax arbitrage” follows from the economic concept of “arbitrage” which refers to obtaining benefits by exploiting pricing differences across different markets.¹³ By analogy, “tax arbitrage” is the phenomenon emerging from transactions designed by taxpayers to take advantage of inconsistencies or disparities between tax systems,¹⁴ such as those relating to tax rates, income qualification or timing, aimed at either double non-taxation or tax deferral.¹⁵

Due to its characteristics, tax arbitrage includes a very broad variety of behaviours and tools used by taxpayers all over the world. However, without doubt hybrid arrangements play a significant role in realizing tax arbitrage.¹⁶ The OECD confirms this position in its report on BEPS Action 2. The OECD provides that “international mismatches in entity and instrument characterization including, hybrid mismatch arrangements and arbitrage” are considered key pressure areas in the fight against the loss of tax revenues, in the protection of tax sovereignty and in ensuring tax fairness for both OECD and non-OECD Countries.¹⁷

There is no agreement among scholars that “tax arbitrage” is a form of tax avoidance. Some scholars claim that tax arbitrage is simply a tax optimization tool and therefore does not have tax avoidance characteristics.¹⁸ Others classify tax arbitrage as tax avoidance because of the outcomes of double non-taxation or tax deferral.¹⁹ Depending on the context, either of the abovementioned viewpoints is correct and therefore a single definitive meaning for “tax arbitrage” is, perhaps, inappropriate.

Tax arbitrage may be considered a tool of tax optimization rather than a form of tax avoidance if it follows from genuine business activities that are not undertaken by taxpayers solely or predominantly to obtain tax benefits.²⁰ For instance, the Colombia input clearly shows that taxpayers may use sophisticated financial instruments in order to achieve efficient project finance goals, or to limit the decision-making powers of “angel investors” with no technical knowledge of the business project developed by the company. The mismatch created by these instruments is often a secondary product of a fundamental business decision and is many times not decisive for the taxpayer. Such use demonstrates that hybrid financial instruments are not

¹³ See L. Gagnon and G.A. Karolyi, *Multi-Market Trading and Arbitrage*, 2003, p. 2. See more on the origin of the notion of “tax arbitrage” in A. Majdańska, *Tax arbitrage a obejście prawa podatkowego*, *Prawo i Podatki* 10 (2011), pp. 12-17.

¹⁴ See the definition for “arbitrage” at the IBFD Tax Glossary.

¹⁵ See more in R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage and International Tax Regime*, 61 *Bull. Intl. Taxn.* 4 (2007), pp. 130-138, *Journals IBFD*; J. Bundgaard, *Cross-Border Tax Arbitrage Using Inbound Financial Instruments Curbed in Denmark by Unilateral Reclassification of Debt into Equity*, 62 *Bull. Intl. Taxn.* 1 (2008), pp. 33-42, *Journals IBFD*.

¹⁶ See M. Brittingham and M. Bulter, *OECD Report on Base Erosion and Profit Shifting: Search for a New Paradigm or Is the Proposed Tax Order a Distant Galaxy Many Lights Years Away?*, 20 *Intl. Transfer Pricing J.* 4 (2013), pp. 238-242, *Journals IBFD*.

¹⁷ OECD, *Action Plan on Base Erosion and Profit Shifting*, (OECD 2013), p. 6, International Organizations' Documentation IBFD.

¹⁸ See H. D. Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System*, 53 *Tax Law Review* 2 (2000), p. 142; A. Krahnal, *International hybrid instruments: Jurisdiction dependent characterisation*, 5 *Houston Business and Tax Law Journal* (2005), p. 115.

¹⁹ See e.g. Avi-Yonah, *supra* n. 15, pp. 137-138; Bundgaard, *supra* n. 15, p. 33.

²⁰ The good example of a tax arbitrage's practice that constituted tax optimization was analyzed by the Court of Justice of the European Union (ECJ), UK: ECJ, 22 Dec. 2010, Case C-277/09, *Commissioners for Her Majesty's Revenue & Customs v RBS Deutschland Holdings GmbH*, [2010] ECR I-13805, paragraphs 20-21 and 50-55, ECJ Case Law IBFD. See also J. Bundgaard, *Hybrid Financial Instruments and Primary EU Law – Part 2*, 53 *Eur.Taxn.* 12 (2013), p. 592, *Journals IBFD*.

only driven by tax but also by sound business reasons, for instance to obtain lower costs of financing, greater financial flexibility and a better credit rating.²¹

While hybrid mismatches may have purposes other than tax avoidance (as determined on a case-by-case basis), the focus of this paper is the use of tax arbitrage via hybrid mismatches to deliberately (mainly) take advantage of inconsistencies or disparities between tax systems in order to achieve tax avoidance, such as deduction with non-inclusion, double deductions, or any other form of reducing the tax burden. Illustrative schemes include examples such as the “Double Irish Dutch Sandwich” which relies on the hybrid mismatch regarding the taxable status of a subsidiary company established in Ireland.²² The term “tax arbitrage” in the context of this study is as a sub-concept of tax avoidance through the use of hybrid mismatch arrangements.

2.2 Preventing tax arbitrage via hybrid mismatches under BEPS Action 2: general description and initial doubts

The OECD in its March 2012 Report on “Hybrid Mismatch Arrangements” listed hybrid arrangements as follows: (i) entities that are treated as transparent for tax purposes in one country and as non-transparent in another country; (ii) entities that are resident in two different countries for tax purposes at the same time; (iii) financial instruments that are treated differently for tax purposes in different countries (e.g. are considered as debt in the country of the capital borrower and as equity in the country of the capital lender); (iv) transfer arrangements that are treated as transfer of ownership for one country’s tax purposes but not for tax purposes of another country.²³ In July 2013 the OECD issued the “*Action Plan on Base Erosion and Profit Shifting*”,²⁴ which focused on a number of practical measures that should be adopted in order to tackle these problems. In September 2014, the OECD published the interim report on Action 2,²⁵ and more recently, in October 2015, the final report on Action 2 was published.

BEPS Action 2 targets only those types of mismatches that rely on a hybrid element that aims at obtaining: (i) deduction/no inclusion (D/NI outcome), i.e. payments that are deductible under the rules of the payer jurisdiction and are not included in the ordinary income of the payee; (ii) double deduction (DD outcome), i.e. payments that give rise to two deductions in respect of the same payment; and (iii) indirect D/NI, i.e. payments that are deductible under the rules of the payer jurisdiction and that are set-off by the payee against a deduction under a hybrid mismatch arrangement.²⁶ Action 2 proposes to neutralize these outcomes of hybrid mismatch arrangements through:

²¹ See Bundgaard, *supra* n. 15, p. 43.

²² In the Google Inc. case, the subsidiary was incorporated in Ireland but locally controlled in Bermuda and therefore the US treated this company as tax resident of Ireland, since US tax law recognizes the jurisdiction of organization or incorporation as the tax jurisdiction (IRC section 7701(a)(4) and (a)(5) (defining foreign and domestic corporations)). Ireland, in turn, considered it as a tax resident of Bermuda, because under the Irish tax law determining corporate residency, a company is resident in a jurisdiction in which actual control of the company resides (Ireland Finance Act 1999, section 82). In consequence of this hybrid entity mismatch, the company’s income was neither taxed in US nor in Ireland. The income was also not taxed in Bermuda, since there is no corporate tax in that jurisdiction. See more C. Fuest, C. Spengel, K.Finke, J. Heckemeyer and H. Nusser, *Profit Shifting and “Aggressive” Tax Planning by Multinational Firms: Issues and Options for Reform*, World Tax J. 10 (2013), pp. 310-312, Journals IBFD; J. Sandell *The Double Irish and the Dutch Sandwich: How Some U.S. Companies Are Flummoxing the Tax Code*, Tax Notes International (2012), 27 August, pp. 868-877. Similar conclusion could be drawn in relation to the scheme of Apple inc., see A. Ting, *iTax—Apple’s International Tax Structure and the Double Non-Taxation Issue*, British Tax Review 1 (2014), pp. 40-71.

²³ OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, (OECD 2012), p. 7, International Organizations’ Documentation IBFD.

²⁴ OECD, *Action Plan on Base Erosion and Profit Shifting*, (OECD 2013), International Organizations’ Documentation IBFD.

²⁵ See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements*, (OECD 2014), International Organizations’ Documentation IBFD.

²⁶ See OECD 2015, *supra* n. 12, pp. 16-17.

“(a) Changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (b) Domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer; (c) Domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under CFC or similar rules); (d) Domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (e) Where necessary, guidance on co-ordination or tie-breaker.”²⁷

Indeed, the domestic anti-hybrid rules recommended by the OECD “take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction”.²⁸ The OECD’s recommended linking rule requires recognition and understanding of the tax provisions of the payee’s country by the payer’s country (primary rule), and vice versa (defensive rule).²⁹

The final report on Action 2 spans 458 pages, making it the most extensive and comprehensive as well as perhaps the most complex and difficult to implement of all the 15 actions of the BEPS project.³⁰ The next part of this study provides the comparative analysis of selected issues of tax arbitrage from hybrid mismatches in the selected developing states while making references to the final report on Action 2 where appropriate.

3 Comparative analysis of selected issues regarding the tax arbitrage via hybrid mismatches among the surveyed developing countries

3.1 Initial remarks on tackling tax arbitrage via hybrid mismatches among the surveyed developing countries

This section provides a comparative analysis of the issue of tax arbitrage via hybrid mismatches among the developing countries surveyed. The reports in response to the questionnaires used for the original fieldwork research submitted by the South Antennas are used as the basis for this analysis.

The reports forming the basis for this paper focused on the problems posed by deductibility regimes across different systems with particular reference to: (i) cases of double deduction (or “double-dip”), where a deduction or loss is claimed for tax purposes in two different jurisdictions and, (ii) cases of misalignment, where the deduction is combined with the non-inclusion of the payment in the income of the recipient.³¹

²⁷ Id., p. 16.

²⁸ Id., p. 11.

²⁹ See A. Rust, *BEPS Action 2: 2014 Deliverable – Neutralising the Effects of Hybrid Mismatch Arrangements and its Compatibility with the Non-discrimination Provisions in Tax Treaties and the Treaty on the Functioning of the European Union*, British Tax Review 3 (2015), p. 324.

³⁰ Since the Report on BEPS Action 2 contains about 458 pages, compared to a total of only 1,500 pages for the reports on the other 14 BEPS actions altogether, it makes the Report on Action 2 being by far the longest 2015 Final Report.

³¹ See also R. Eicke, *Tax Planning with Holding Companies – Repatriation of US Profits from Europe*, Alphen aan den Rijn: Kluwer Law International, 2009, pp. 24 and 378 et seq. Such issues have been identified as key areas of intervention also by the OECD in its BEPS Project, see, in particular, OECD 2015, *supra* n. 12, p. 17, in particular, paragraphs 7 and 8.

In sections 3.2. to 3.6. that follow, the South Antenna reports provide the basis for the comparative analysis, with an emphasis on: surveying the perception of the problem of cross-border tax arbitrage arising from hybrid mismatches among a selected pool of developing countries; putting the respective systems to test in the light of some prevailing hybrid mismatch pattern; and, most importantly, testing potential solutions to the problem.

Many of the solutions proposed in Action 2 may not appear strikingly innovative in isolation. Nevertheless, a mix thereof may be successful in striking a balance between effectiveness and sustainability. A key innovative element in this respect may be represented by the possibilities offered by forms of enhanced administrative co-operation in the area of information sharing. In particular the sharing of relevant experiences with respect to hybrid mismatch arrangements and its impact on the deterrence, detection and reaction strategies that developing countries could adopt when addressing this issue, may be useful.

The following aspects arising from the surveyed countries will be addressed:

- (i) general perception of tax arbitrage utilizing hybrid mismatches (section 3.2.);
- (ii) an in-depth overview of the case studies outcomes concerning tax arbitrage via hybrid mismatches (section 3.3.);
- (iii) the current and prospective domestic and tax treaty provisions and practice against tax arbitrage achieved using hybrid mismatches (section 3.4);
- (iv) current and potential reactions of the surveyed countries to OECD inputs within the BEPS project (section 3.5);
- (v) some policy perspectives (section 3.6); and finally
- (vi) section 4 of this study provides the conclusions and recommendations regarding the way of addressing tax arbitrage via hybrid mismatches by surveyed countries.

3.2 General perception of tax arbitrage utilizing hybrid mismatches

In general there is evidence in the public domain, that South Africa has considered tax arbitrage arising from hybrid mismatches while in Colombia, Brazil, and Uruguay it is less evident when considering the documents publicly available.

One of the first initiatives on the issue, in Colombia, was discussed in the “Jornadas Colombianas de Derecho Tributario” (ICDT) in the context of the DeSTaT Project. More recently, in May 2016, Colombia has actively participated in all BEPS discussions including the approval of Action 2. Furthermore, at the III Conference on International Taxation that took place in Bogota at Universidad del Rosario on May 18th and 19th, 2016,³² the Colombian advisor to the Tax Administration Chief on International Tax Policy noted that Colombia is reviewing the possibility of denying a deduction whenever the taxpayer cannot demonstrate that the income has resulting in taxation paid in the jurisdiction of the recipient. It is noteworthy that the three top administrative officers dealing with international tax issues, all of which spoke at the above conference, hold international tax graduate degrees in Europe or the US all of which would have addressed the issues related

³² See online: <http://actl.uva.nl/news-events/events/content/conferences/2016/05/international-tax-conference-bogota---colombia---18-19-may-2016.html>.

to tax arbitrage via hybrid mismatches.³³ The Colombian reporter further noted that tax practitioners are widely aware of the methods of reducing or avoiding tax burdens via hybrid mismatches and occasionally organize events to discuss tax-planning opportunities through the use of mismatches.³⁴ Unfortunately, there has been no dialogue between tax practitioners and the tax administration on the use of hybrid mismatches.

The reporters for Brazil and Uruguay noted that neither tax administration nor the Brazilian and Uruguayan academic community have, to date, extensively addressed specific initiatives concerning tax arbitrage via hybrid mismatches.³⁵

The South African response to hybrid mismatches differs significantly from the other countries analysed. Firstly, the South African Government has signalled its concern with hybrid debt instruments and arrangements that create a tax deduction in South Africa without that amount being taxed elsewhere.³⁶ Secondly, legislative amendments aimed at addressing the issues of international tax arbitrage and hybrid mismatches have been introduced, e.g. hybrid debt instrument rules³⁷ and debt limitation rules on loans with non-resident connected persons.³⁸

The South African reaction to tax arbitrage via hybrid mismatches likely follows from its membership of the G20. South Africa is a co-signatory of the September 2013 G20 Leader's Declaration in which the OECD's BEPS programme was endorsed³⁹, and the OECD's Declaration on Base Erosion and Profit Sharing.⁴⁰

Although Brazil is a member of the G20, its response to hybrid mismatches has not accelerated at the pace of South Africa. The differing reaction levels may be attributable to a number of different factors such as the willingness of South Africa to pilot or participate as a first adopter to numerous anti-avoidance initiatives. South Africa also has a larger network of treaties⁴¹ facilitating exchange of information which may be used to

³³ In the case of Natalia Aristizabal, who is the lead administration advisor on international tax and is tasked with participating in the OECD and the Global Forum, she holds an LLM (international tax programme) from Harvard. José Alejandro Mejía, who is the Subdirector for International Tax, he has a Masters on International Tax Law from Panthéon Assas (Paris II) and is often in Paris with the Committee for Fiscal Affairs (CFA) at the OECD. Finally, Oswaldo González, who is the advisor for tax treaty negotiations, holds an LLM in International Tax law from FU and is usually tasked with US tax issues. In addition to these people, there are other officers and contractors that were educated in international tax amongst others in New York University (NYU), Leiden, or the Vienna University of Economics and Business (Wirtschaftsuniversität Wien, WU). As noted by D. Quiñones at the Conference on "A Sustainable Path for Tax Transparency in Developing Countries", see online: <http://www.jus.uio.no/ior/english/research/projects/global-tax-transparency/events/conferences/a-sustainable-path-for-tax-transparency-in-develop.html> (27 June 2016).

³⁴ Colombia report at 5.

³⁵ Brazil report at 5; Uruguay report at 6-7.

³⁶ SARS Media Rules of 29 April 2013, *Request for Public Comment for Incorporation into Forthcoming 2013 Tax Laws Amendment Bill: Proposed Limitations Against Excessive Interest Tax Deductions*, available online at: <http://www.sars.gov.za/Media/MediaReleases/Documents/Media%20Release%2029%20April%202013%20-%20Proposed%20limitations%20against%20excessive%20interest%20tax%20deductions.pdf>. Moreover, the role of hybrid financial instruments in tax avoidance arrangements was discussed in SARS discussion paper of November 2005 on the proposed revision to the general anti-avoidance provisions of section 103 of the Income Tax Act, Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), Prepared by Law Administration South African Revenue Service (November 2005), para 6.3.1, p25, available online at: <http://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2005-01%20-%20Discussion%20Paper%20Tax%20Avoidance%20Section%20103%20of%20Income%20Tax%20Act%201962.pdf>.

³⁷ Section 8F and 8FA of the Income Tax Act.

³⁸ Section 23M of the Income Tax Act

³⁹ G20 Leader's Declaration, September 2013, para 12, available online at: https://www.g20.org/sites/default/files/g20_resources/library/Saint_Petersburg_Declaration_ENG.pdf.

⁴⁰ OECD Declaration on Base Erosion and Profit Shifting, available online at: [http://www.oecd.org/tax/C-MIN\(2013\)22-FINAL-ENG.pdf](http://www.oecd.org/tax/C-MIN(2013)22-FINAL-ENG.pdf).

⁴¹ South Africa report at 3-4, with reference to tax treaties including exchange of information's provisions, the OECD's Convention on Mutual Administrative Assistance in Tax Matters, several bilateral tax information exchange agreements (TIEAs), and an intergovernmental FATCA agreement with the US.

facilitate the identification of tax arbitrage via hybrid mismatches. There also appears to be greater engagement with the topic by legal commentators in South Africa.⁴²

There is no readily available evidence to suggest that the high awareness of the tax arbitrage problem in question in South Africa triggers either a co-operative or a confrontational stance between tax practitioners and the tax administration.⁴³

3.3 In depth overview of case studies concerning country perspectives on tax arbitrage via hybrid mismatches

Sections 3.3.1 and 3.3.2 contain an analysis of cases which trigger two classical misalignments stemming from hybrid mismatches: (i) a deduction or loss is claimed for tax purposes in two different jurisdictions (double deduction (or “double-dip”), and (ii) the deduction is combined with the non-inclusion of the payment in the income of the recipient. Many of the questions that occur in these case studies have not been discussed in the surveyed countries before and therefore some of them could not be answered and answers to others have been elaborated on by the reporters without them being able to refer to domestic practice in their countries. Thus, many of their answers go beyond the mere “reports” and constitute creative ideas that may serve as a starting point for further discussions on the prevention of tax arbitrage through hybrid mismatches in the surveyed countries.

In section 3.3.3 selected countries’ perspectives on tax arbitrage via hybrid mismatches are analysed. These include: existing case law on tax arbitrage via hybrid mismatches (section 3.3.3.1.), theoretical cases and schemes of tax arbitrage via hybrid mismatches in surveyed countries (section 3.3.3.2.), differences (if any) between tax arbitrage carried out by multinational corporations and high net worth individuals (section 3.3.3.3.), and finally revenue effects of tax arbitrage via hybrid mismatches on the tax systems of the surveyed countries (section 3.3.3.4.).

In the case studies that follow in sections 3.3.1 and 3.3.2, the reporters were asked to analyse, on the basis of statutory law and case law, whether the arrangements described in the five following hypothetical examples might be carried out with the involvement of an entity situated in their country by adopting both the perspective of country A and country B, i.e. in scenario A and B below. Where assumptions were inapplicable in the surveyed country, the reporters sometimes provided responses amending the scenario to reflect the tax treatment of the entity.

3.3.1 Double deduction

3.3.1.1 Double deduction (I) (making use of a hybrid subsidiary borrowing money)

The following assumptions were made under the first case triggering double deduction (see also Diagram I below):

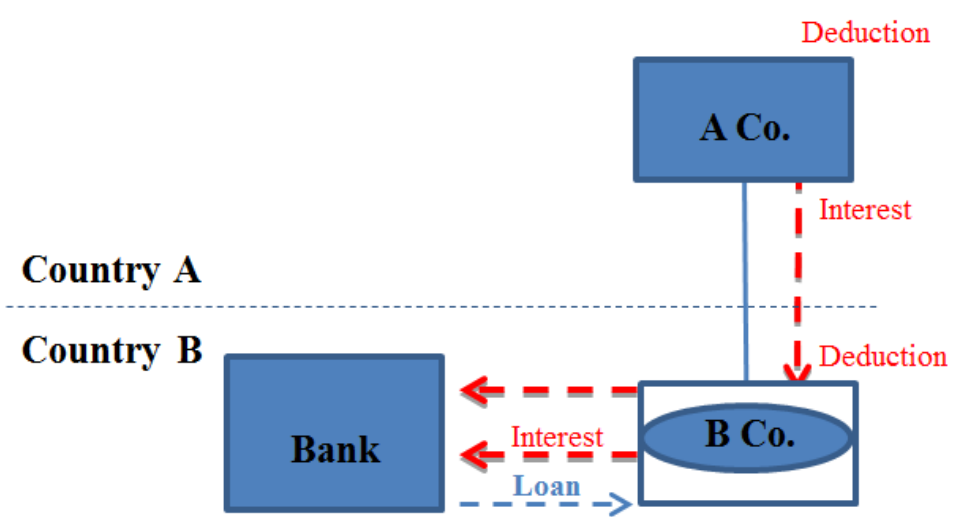
⁴² See particularly *Silke on International Tax*, chapter 8, Cape Town: LexisNexis, South Africa; Professional Tax Handbook 2013/2014.

⁴³ South Africa report at 4.

- (i) a parent corporation (A Co.) that is resident in Country A owns a subsidiary that is resident in Country B (B Co.);
- (ii) B Co. is treated as a corporation for Country B tax purposes but is treated as a tax transparent partnership/permanent establishment (PE) of the parent corporation for Country A tax purposes;
- (iii) B Co. issues debt to a third party (Bank) and it incurs interest expenses;
- (iv) B Co. deducts the interest for Country B tax purposes;
- (v) the parent (A Co.) also deducts the interest for Country A tax purposes because the subsidiary (B Co.) is treated as a tax transparent partnership/PE of the parent for Country A tax purposes, and therefore the parent – which is the head office from the perspective of country A – is treated as paying the interest paid by the subsidiary/PE for Country A tax purposes.

The taxpayer has designed the scheme only for deducting the same interest expense twice (in Country A and in Country B) and therefore we may conclude that the scheme represents tax arbitrage (avoidance) via hybrid mismatch. The double deduction would be possible only if Country A has in force rules allowing for the subsidiary in Country B to be treated as a tax transparent partnership (or rules similar to the US “check the box” with an option to treat the subsidiary as tax transparent partnership). The first question is therefore whether surveyed countries have such rules in force. A further variation considers the consequences of this scheme for countries with CFC rules (Brazil/South Africa/Uruguay) and without CFC rules (Colombia), as well as countries (where head office is located, i.e. Country A) taxing income attributed to a PE (Colombia) and countries exempting such income from taxation (Uruguay).

Diagram I: Double Deduction (I)



Scenario A: Country A is the surveyed country

The reporters of all surveyed countries agreed that this scheme would not achieve the desired effects from the perspective of their countries if it would be Country A for a variety of reasons. The failure of this scheme took no cognisance of the deduction of expenses by the subsidiary in Country B. Expenses incurred abroad by a subsidiary would not be deductible in their Countries.⁴⁴

In Uruguay, due to the territorial tax system, whether the company in Country B is treated as a tax transparent partnership or as a subsidiary is irrelevant. Thus, interest paid as expenses by the foreign tax transparent partnership/PE of the parent Uruguayan company will be disregarded for Uruguayan tax purposes.⁴⁵

The Brazilian reporters explain that even though positive and negative results earned by foreign entities controlled by Brazilian parent companies may be consolidated for purposes of application of the Brazilian CFC rules until 2022,⁴⁶ the scheme is not effective in this case as foreign branches of Brazilian companies are fictitiously treated as *separate* legal entities (e.g. subsidiaries of Brazilian parents). The interest would be considered as an expense of the foreign branch and not of the Brazilian headquarters.⁴⁷ This means that the Brazilian company will add the branch's profit before tax (but post deduction of the interest) to its taxable basis under the Brazilian CFC rules. Conversely, if the branch had losses, these losses are only deducted against foreign profits of other branches. Hence, the foreign interest expense cannot be recognized as an expense incurred in Brazil for Brazilian income tax purposes.

⁴⁴ See Brazil report at 6; Colombia report at 8; South Africa report at 8; and Uruguay report at 8.

⁴⁵ As a matter of fact, this is the same result as in countries with worldwide tax systems (tax resident taxpayers are liable for their worldwide income), which exempt foreign income of tax residents from taxation. For example, many EU member states exempt certain types of foreign sourced income (usually active income) of their own residents from taxation while applying the exemption method of avoidance of double taxation, see Y. Brauner, *An International Tax Regime in Crystallization*, 56 Tax Law Review 2 (2003), pp. 286-287; H.J. Ault, and B.J. Arnold, *Comparative Income Taxation: A Structural Analysis*, 2nd edition, Alphen aan den Rijn: Kluwer Law International, 2004, pp. 357-360; K.S. Blanchard, *BEPS Action 3: How Not to Engage with CFC Rules*, Premier International Tax Library 2015, 1 July 2015, access online: <http://www.bna.com/beps-action-not-n17179928956/>. As a result of the exemption of foreign sourced active income (such as PE's income), losses or interest incurred in connection with such income of tax residents are not allocated to the residents.

⁴⁶ See F. Tonanni and N. Gomes, *Brazil - Corporate Taxation - Country Analyses*, IBFD: Amsterdam, Tax Research Platform (Last Reviewed: 20 October 2015), p. 39.

⁴⁷ Article 1, §1° of Law 9,532/1997 and Article 89 of Law 12,973 of 2014.

The Colombian reporter stated that the scheme would not work if Colombia is Country A as Colombia does not have autonomous rules for classifying a foreign entity as a tax transparent partnership. Deduction of the interest expense in Colombia would be possible only if the subsidiary was found to constitute a PE of the Colombian company under a tax treaty and if the interest expense was attributable under the treaty to the Colombian company and not to the PE. However, such rules are very unlikely and do not apply in these cases. Hence, the deduction in Country B would not be possible, which does not achieve the desired tax avoidance outcome.

Finally, the South Africa reporter indicated that the example assumption to treat the foreign subsidiary as tax transparent would not hold true in South Africa as no provision exists to allow for such treatment. Accordingly, the interest incurred by the subsidiary would not be deductible by the South African parent. The South African reporter also explained that even though South Africa does have CFC rules which may operate to include the subsidiary's net income in the parent's taxable income, these rules would not permit a net loss to be included in the parent company's taxable income. Thus it would seem that the South African CFC rules would not operate to facilitate a double deduction of this interest (likewise in case of the Brazilian CFC rules).

Scenario B: Country B is the surveyed country

In this scenario, the reporters of all surveyed countries agreed that their countries could be involved in such a scheme as Country B, unsurprisingly, would allow a deduction for interest. While the Uruguayan reporter did not indicate any tax provisions that may be used to strike down this scheme from operating in Uruguay,⁴⁸ observations and caveats were provided by other reporters. The Colombian reporter observed that the above double deductions scheme is a common tax planning structure in the financial industry in Colombia as no legal basis exists in Colombia to undermine its effects if the subsidiary is a Colombian resident taxpayer.⁴⁹ The South African reporter warned that success of such a scheme may be neutralised via the GAAR,⁵⁰ if the involvement of the South African subsidiary and/or loan arrangement in this scheme did not have commercial substance.⁵¹

The Brazilian reporters equally noted no tax provision in force in Brazil which prevents an undue tax deduction in a foreign jurisdiction derived from interest expenses incurred in Brazil.⁵² They further noted that the presence of tax transparent partnerships/PE of foreign legal entities in Brazil is very uncommon due to the onerous requirements and bureaucratic hurdles involved. In practice in Brazil the local presence of foreign entities in Brazil is in the form of a locally incorporated subsidiary. Moreover, Brazilian legislation on permanent establishments is not usually enforced because the tax administration treats the direct local presence of foreign entities as a resident taxpayer and subjects their payments abroad to withholding tax. Accordingly, the involvement of Brazil in this scheme as Country B is possible, but it follows merely from the treatment of the Brazilian parent company as tax transparent by Country A. The success of such a scheme

⁴⁸ See Uruguay report at 8.

⁴⁹ See Colombia report at 8.

⁵⁰ Section 80A of the Income Tax Act (ITA), Act No. 58 of 1962).

⁵¹ See South Africa report at 9.

⁵² See Brazil report at 6.

in Brazil (and generally the other surveyed countries) does not follow from the local tax law, but from the foreign tax law.

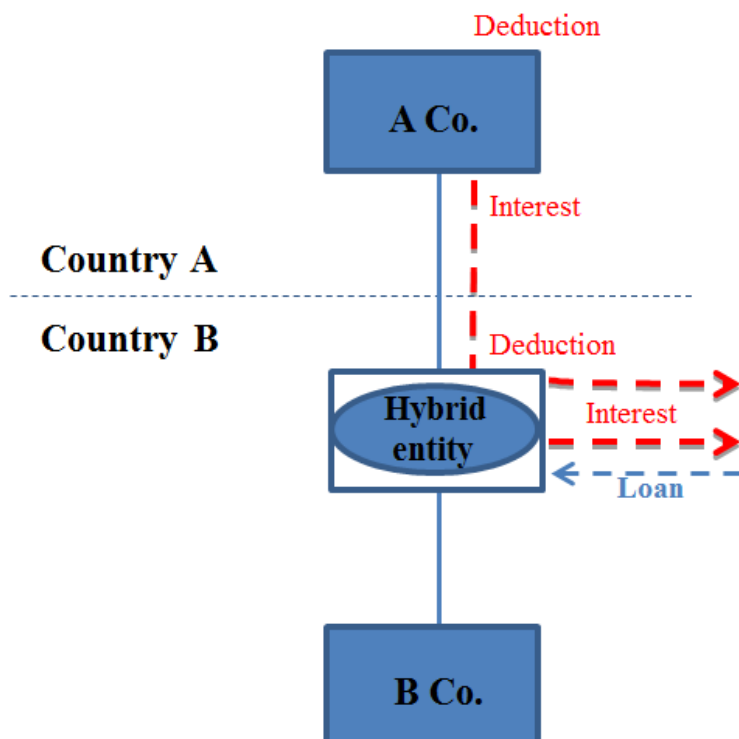
3.3.1.2 Double deduction (II)⁵³ (making use of an intermediary hybrid entity borrowing money)

The following assumptions were made under the second case triggering double deduction:

- (i) a holding company in Country A indirectly holds an operating company in Country B;
- (ii) the indirect control is exercised through a hybrid entity situated in Country B;
- (iii) in particular, the hybrid entity would qualify as transparent from the perspective of Country A and opaque from the perspective of Country B;
- (iv) the hybrid entity in Country B borrows money and uses the loan for a capital contribution into the operating company in Country B;
- (v) the hybrid entity in Country B pays interest on the loan;
- (vi) for Country B purposes the hybrid entity can deduct interest expenses from its corporate income;
- (vii) for Country A purposes the hybrid entity is a pass-through, so that the holding company in Country A can deduct the same interest expenses.

Consequently, this scheme's purpose is to deduct the same interest expenses in Country A and in Country B.

Diagram II: Double Deduction (II)



Scenario A: Country A is the surveyed country

⁵³ Cf. "double deduction" with hybrid entity example in OECD (2012), *supra* n.23, paragraphs 13-15 at p. 8.

The reporters of Brazil, Colombia, and Uruguay concluded that their countries could not be involved in such a scheme as Country A with assumed effects of the scheme for the same reasons as in the previous case (Double Deduction I: Scenario A).⁵⁴

The reporter of South Africa analysed this case under two assumptions. In the first instance, it was assumed that the hybrid entity is assumed to be a trust which is a resident in Country B. If the income net of trust expenses is vested in the holding company resident in South Africa, the South African tax law would effectively permit the double deduction. In the second instance, the hybrid entity is assumed to be a partnership resident in Country B. In this instance, the double deduction would not occur if the holding company is resident in South Africa, irrespective of the tax treatment of the partnership by a country of its location (Country B). The South African tax law does not allow for a deduction of an interest expense incurred either for purposes of producing foreign dividends or for purposes of a foreign return of capital, i.e. taking a loan in order to buy shares in a company from which the dividends will be distributed or capital gains will be received upon the disposal of the shares.⁵⁵

Both the trust and partnership hybrid entities were considered in the Colombian report. The Colombian reporter stated that the trust assumption would not work as Colombia only treats domestic trusts as transparent. Foreign trusts are treated as opaque. The Colombian entity would only pay tax on distributions from the trust or could include a tax loss upon the liquidation of the trust, provided that the value is depreciated compared to the last valuation reported by the Colombian company for the investment in the trust. The partnership assumption would also not achieve the intended result of this case study. All entities, apart from domestic trusts, are treated as opaque. Consequently, considering both trusts and partnerships, there is no possibility of a mismatch where Colombia acts as Country A.

In the Brazilian context, the Brazilian legislation does not provide for transparent entities. As a result, neither a trust or a partnership could be used to achieve the outcome in this case. Specifically, the trust assumption cannot not apply to Brazil as there is no legislation on trusts nor any other form of segregated assets with similar features. A foreign trust would therefore be recognised as a company (assuming the holding company acts as the trustee). Similarly, a partnership would be an opaque entity for Brazilian purposes.

As Uruguay has no tax legislation with respect to trusts or partnerships, the case would not achieve the desired result in Uruguay.

Scenario B: Country B is the surveyed country

Apart from the South African reporter,⁵⁶ all other surveyed countries reported that this case would achieve the desired result where their country acted in the position of country B.⁵⁷ This is perhaps unsurprising as in this case, Country B sees the hybrid entity as opaque, aligning its treatments with that of other corporate entities. However, the reporters of Brazil cautioned that the deduction of the interest payments for the hybrid

⁵⁴ See Brazil report at 7; Colombia report at 9; and Uruguay report at 9.

⁵⁵ See section 23(q) in conjunction with section 1 and section 11(1)(a) of the ITA. See South Africa report at 11-12.

⁵⁶ This regards situations in which the hybrid entity is either a trust or a partnership according to South African tax law. See South Africa report at 12-13.

⁵⁷ See Brazil report at 7; Colombia report at 9; and Uruguay report at 9.

entity in Brazil may be challenged by the tax authorities if the payments do not qualify as “necessary expenses”.⁵⁸ One should also bear in mind that the interest payments are associated with income from dividends which are exempted from taxation in Brazil and therefore the deductibility may work in practice only if the hybrid entity has other taxable income against which the interest can be offset.⁵⁹ A challenge against the interest deduction may also be possible in Colombia for similar reasons. It would also appear that this case is unlikely to arise in South America (based on the reports of Brazil, Colombia and Uruguay) as the tax legislation in these countries does not appear to cater for tax transparent partnerships. Accordingly, the two assumptions, as reported by the South African reporter below, are not applicable for Brazilian, Uruguayan, and Colombian tax purposes.⁶⁰

South Africa does recognise both partnerships and trusts (usually) as transparent entities. For a partnership, the case will not bring the desired result of double deduction as the assumption to treat the hybrid entity (partnership) as opaque in South Africa would not hold true. As a result of the entity being tax transparent in both Country A and Country B (South Africa), the double deduction does not arise. Where the hybrid entity is a trust, the ineffectiveness of the scheme in the South African reporters’ view is caused by the lack of the possibility to deduct interest payments by the hybrid entity (trust), since the interest is neither incurred for purposes of a “trade” carried on by this entity⁶¹ nor is the trust a company acquiring equity shares in an operating company.⁶² As a result, the interest deductibility would fail in the trust.

3.3.1.3 Interim conclusions in respect to the effectiveness of Double Deduction schemes

The analysis so far shows that both envisaged double deduction schemes (I) and (II) would not lead to the double deduction outcome whenever a surveyed country would be Country A (scenario A), i.e. a residence country of a parent company providing a loan to a foreign subsidiary. The only exception exists in relation to South Africa in scheme (II) under the assumptions that the hybrid entity situated in Country B is a trust and income net of trust expenses is vested in a holding company resident in South Africa. Beyond this limited instance, no double deduction occurs. This mainly follows from the fact that none of the surveyed countries have in force tax provisions to treat a foreign subsidiary as a tax transparent entity. Moreover, in the case of Uruguay, the said consequence is caused by its territorial tax system, that is the interest paid by a foreign subsidiary of the parent Uruguayan company will be disregarded for Uruguayan tax purposes, likewise the income derived by the subsidiary.

Key to the failure of scenario A for both double deduction cases (see sections 3.3.1.1. and 3.3.1.2.) are the following:

⁵⁸ However, the Administrative Board of Tax Appeals (CARF) has twice decided favourably to the deductibility of interest expenses incurred in connection with the acquisition of equity interest, see Decision n. 101-96.152, of May 23, 2007 (“the PMPAR case”) and Decision n. 107-09.420, of June 25, 2008 (“the Unilever case”). See Brazil report at 7.

⁵⁹ See Brazil report at 7.

⁶⁰ Apart from tax treatment of domestic trusts in Colombia as tax transparent. Nevertheless, the scheme would work in Colombia only if the hybrid entity was a partnership or a corporation that has been “checked-the-box” in Country A (the US). It would not work if the company chose a domestic trust as a hybrid entity, as interest would not be deductible in the Colombian trust. The point is, though, that it would not make sense for a foreign investor to choose a domestic trust in Colombia when it can choose a corporation or partnership that can easily be “checked” under jurisdictions such as the US.

⁶¹ See *Solaglass Finance Company (Pty) Ltd. v Commissioner for Inland Revenue* (125/1989) [1990] ZASCA 157; 1991 (2) SA 257 (AD); [1991] 1 All SA 339(A) (30 November 1990). See also S11(a) of the ITA read with S23(g) of the ITA.

⁶² See S24O(2) of the ITA.

- (i) For Uruguay, the application of a territorial tax system;
- (ii) For Brazil and Colombia, the treatment of such hybrid entities as opaque in all instances, or deeming rules classifying such entities as opaque;
- (iii) While South Africa would recognise the hybrid entity as transparent, various limitations prevented the success of the cases. Furthermore, in the case of a foreign partnership, only profits would be consolidated into the resident taxpayer's taxable income. Foreign losses may not be set off against domestic profits.

Conversely the double deduction outcome could be achieved in Brazil, Colombia, and Uruguay in scenario B for both double deduction cases (see section 3.3.1.1. and 3.3.1.2.), i.e. where the surveyed country is the residence country of an intermediary hybrid subsidiary paying interest to the parent. The success of the cases in each of these countries may be due to a lack of legal tools for detecting the hybrid treatment of such entities in the other State. In addition, there appears to be a lack of anti-hybrid rules to adequately neutralize the effect of the scheme in these countries.⁶³

For South Africa in case of double deduction (I), while double deduction may be possible, there is a risk that the GAAR may be applied by tax authorities to neutralize the double deduction outcome if the involvement of the South African subsidiary and/or loan arrangement in this scheme does not have commercial substance. In case of double deduction (II) the desired outcome of double deduction is not achieved. The failure of this case is as a result of anti-hybrid rules, but rather as a result of the general rules for the taxation of partnerships⁶⁴ and the general rule for the deductibility of interest.⁶⁵

3.3.2 Deduction/non- inclusion

3.3.2.1 Deduction/non-inclusion (I)

The following assumptions were made under the first case triggering deduction with non-inclusion:

- (i) A holding company situated in Country H (Holdco H) controls a subsidiary in Country A (Subco A) and a subsidiary in Country B (Subco B);
- (ii) the subsidiary in Country A is a partner of a partnership established in the same Country;
- (iii) the subsidiary in Country A receives a bank loan;
- (iv) the resources provided by the loan are invested in the partnership in Country A in the form of an equity contribution;
- (v) the partnership lends money to the subsidiary situated in Country B;
- (vi) interest paid by the subsidiary in Country B to the partnership in Country A is deductible in the former Country;

⁶³ The Colombian reporter explained that the analysed transactions would only be seen as hybrids if Colombia obtains information on the treatment abroad by means of an MDR, spontaneous exchange of information or a whistle-blower. Then the GAAR could be applied. However, the taxpayer could still demonstrate a business purpose or compliance with the transfer pricing regime.

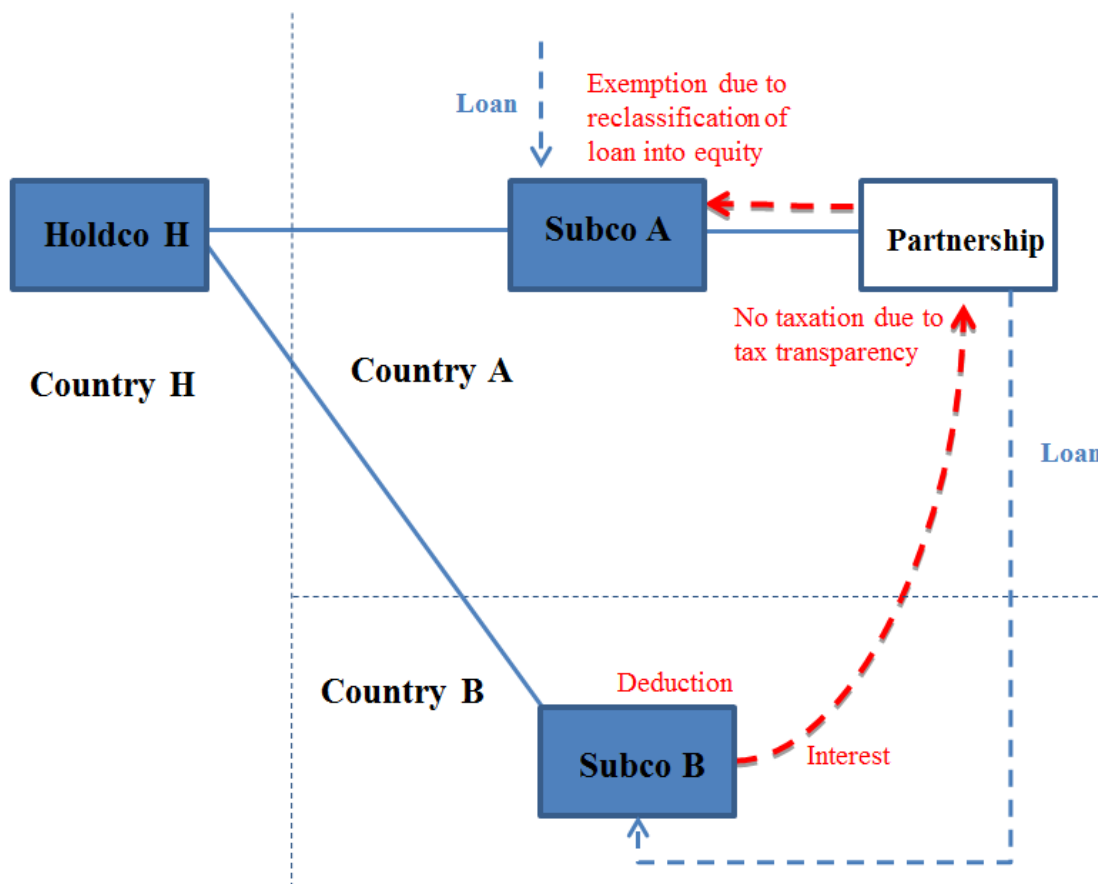
⁶⁴ All partnerships are transparent entities for South African tax purposes and therefore whenever a partnership located in South Africa is tax transparent from the perspective of a country of residence of its foreign partner, the double deduction effect assumed in the double deduction case (II) (see section 3.3.1.2.) does not appear.

⁶⁵ The interest expense would need to be incurred for purposes of a "trade" carried on by the entity paying the interest (noting that the earning of dividend income is not a trade). Alternatively, where the entity is a company, the interest may be taken into account on a loan to acquire equity shares in an operating company. As the hybrid entities were not companies, the case failed.

- (vii) the interest income is not taxable in the hands of the partnership in Country A, because the partnership is tax transparent under tax law of Country A;
- (viii) the interest income is re-characterised from income from a bank loan provided by the partnership in Country A into income from equity in the hands of the subsidiary in Country A and Country A provides for exemption for such kind of income;
- (ix) Country H features CFC rules. However, as a result of the exemption of the income from equity, there is no income to be attributed on the holding company.

This scheme's intention is to achieve deduction of interest in Country B with non-inclusion of this interest in Country A.

Diagram III: Deduction/non-inclusion (I)



Scenario A: Country A is the surveyed country

From the reports from Brazil and Colombia it is clear that the above case would not have the anticipated result of deduction on the one-hand and non-inclusion of interest on the other. As Brazilian and Colombian tax law does not provide for transparent partnerships, the assumptions in (vii) and (viii) above cannot be met and the case must fail.⁶⁶ In other words, there can be no re-characterization of the income from the loan provided by the partnership to Subco B into income from equity. Therefore, a non-inclusion of the income from interest does not occur in Brazil and Colombia.

⁶⁶ See Brazil report at 8 and Colombia report at 10. As further explained by Brazilians reporters, even silent partnerships in Brazil are subject to tax individually as separate legal entities.

Equally, this scheme cannot bring the desired outcome of deduction/non-inclusion of interest payments in Uruguay, because a partnership, which has a resident company as its partner, is not transparent for tax purposes and therefore the interest income of the partnership would be taxable at its level. Similar to Brazil and Colombia, the assumption under points (vii) and (viii) cannot be met and the case must fail.⁶⁷

The South African report indicates that the partnership will be transparent for South African tax purposes and therefore Subco A, who is its partner, will be treated as having received or accrued its share of the interest on the loan provided by the partnership to Subco B. Accordingly, the scheme will not work in South Africa as the income could not be re-characterised. In South Africa, the Supreme Court of Appeal has confirmed⁶⁸ that the transparency of the partnership operates at the micro level (i.e. individual items of income and expenses accrue or are deductible by the individual partner in terms of their profit share)⁶⁹ rather than the macro level (where, for example, the profit would be separately determined and only the net result attributed to the partners. While re-characterisation may take place where the transaction is considered a sham by the courts,⁷⁰ it is unlikely that this case (or the other constructs in this paper) are of the type to be considered sham transactions.

Moreover, it is worth noting that the report of South Africa includes, among others,⁷¹ a reference to the Supreme Court of Appeal's judgment of 12 and 20 May 2005 concerning the recoupment of allowances claimed in respect of a partnership asset on exit of a partner.⁷² The court confirmed in particular the operation of section 24H of the ITA (1962): what accrues to the individual partners is not a share of the taxable income of the partnership but rather a share of the gross income of the partnership against which the partner is allowed a deduction of attributable expenses and allowances. This includes the partner's share of partnership expenses and allowances.⁷³ It means that from the South African standpoint only the partner of a partnership, instead of the partnership itself, can deduct interest incurred by the partnership. This indirectly influences the effectiveness of the use of hybrid arrangements involving partnerships, such as the one discussed in this section.

The Colombian reporter referred to the judgment of a lower court (the Tribunal Administrativo de Cundinamarca) of 23 November 2013 dealing indirectly with a hybrid mismatch. The judgment neither directly nor indirectly affects the effectiveness of tax arbitrage via hybrid mismatches, but may have an influence on the size of tax benefits resulting from it. The case concerned the valuation of a hybrid instrument at the time of the sale of said instrument. The tax administration wanted to apply equity valuation under the net book value method. The taxpayer argued that the instrument should be valued as debt which lowers a valuation of the hybrid instrument for tax purposes. The judgment was completely in favor of the

⁶⁷ However, such income is foreign sourced and thus it will not be taxable in Uruguay. See Uruguay report at 10.

⁶⁸ *Chipkin (Natal) (Pty) Ltd V Commissioner for the South African Revenue Service*, ([2005] 3 All SA 26 (SCA)) 67 SATC 243.

⁶⁹ See South Africa report at 20.

⁷⁰ It regards case law on "sham transaction" in which courts looked through the legal form of transaction by giving effect to the real transaction rather than its purported form. See, for example: *Zandberg v Van Zyl*, 1910 AD; *Erf 3183/1 Ladysmith(Pty) Ltd And Another V Commissioner For Inland Revenue*, 1996 (3) SA 942 (A), 58 SATC 229; *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd*, 1941 AD; *Commissioner for the South African Revenue Service v NWK Ltd*, 2011 (2) SA 67 (SCA); and *Roshcon (Pty) Limited v Anchor Auto Body Builders CC and Others*, (49/13) [2014] ZASCA 40; [2014] 2 All SA 654 (SCA); 2014 (4) SA 319 (SCA) (31 March 2014).

⁷⁴ See Brazil report at 8 and Colombia report at 10.

⁷⁴ See Brazil report at 8 and Colombia report at 10.

⁷⁴ See Brazil report at 8 and Colombia report at 10.

taxpayers, as it holds that the tax administration has the obligation to take into account the limitations on the privileged stock as established by the taxpayer in the bylaws and issuance articles for class A stock. The judgment also recognized that the stock was issued more in the context of debt than as regular equity. It thus confirmed the taxpayers' valuation and annulled the tax administration assessment. However, the judgment was appealed by the tax administration. The judgment ruling is expected in 2017.

Scenario B: Country B is the surveyed country

Where either Brazil or Colombia are the surveyed countries, the scheme could work with the desired result of the deduction in their countries and the non-inclusion assumed in a foreign country (Country A).⁷⁴ However, the Brazilian reporters cautioned that the Brazilian tax authorities may establish limitations to the interest deductibility of the subsidiary in Country B by applying transfer pricing and thin capitalization provisions.⁷⁵ Moreover, the Administrative Board of Tax Appeals (CARF) in Brazil in its decisions have challenged interest deductibility in connection with loans that were deemed to have an equity nature based on the argument that these expenses were not considered as "necessary expenses".⁷⁶ As the reporter stated, the underlying rational influences the qualification of an instrument as debt or equity which, in turn, has an indirect impact on the effectiveness of schemes involving hybrid arrangements.

The Uruguayan report suggests that this scheme cannot bring the expected outcome of deduction/non-inclusion of interest payments. The Uruguayan subsidiary (Subco B) in this case will not be able to deduct the interest payments to the partnership. Interestingly the Uruguayan tax law does not allow for deductibility of interest payments made by a Uruguayan company if the payments do not constitute taxable income for the lender (a form of linking rule).⁷⁷ Such domestic law speaks directly to this case, since the income from interest payments made by the Uruguayan subsidiary (Subco B) do not constitute taxable income to the partnership due to its tax transparency in Country A.⁷⁸ Furthermore, the report shows that even if the income is taxable at the level of the partners, that is Subco A, the failure of this scheme remains unchanged as, from the perspective of the Uruguayan law, the partnership is the lender, not its partners.

The South African report indicates that this case would be successful, but subject to certain limits. To succeed, the interest paid by the South African subsidiary (Subco B) to the partnership together with other interest paid to non-resident connected persons and exempt bodies must not exceed 40 percent of earnings before interest, taxes, depreciation and amortization (EBITDA),⁷⁹ and the hybrid debt rules must not operate to deem the interest to be a dividend in specie.⁸⁰ From a South African perspective, the case provides

⁷⁴ See Brazil report at 8 and Colombia report at 10.

⁷⁵ See Brazil report at 8.

⁷⁶ According to the reporter, the arguments were as follows: "The same goals reached with the debt transaction could have been attained via equity (considering that the lender was the mother company of the borrower). This would point out the lack of necessity of the debt transaction". See Decision of August 24 2009 in *the Colgate case*, Case No. 9101-00.287. In this decision, the interest deductibility was denied. "The necessity of the expenses should be analysed vis-à-vis the company's trade or business. In this regard, the acquisition of equity interest in another company would per se not qualify as a necessary expense". See *Unilever and PMPAR* cases, in which the interest deductibility was accepted.

⁷⁷ Law 18,083, "regla candado". See Uruguay report at 10.

⁷⁸ See assumption number (vii) above.

⁷⁹ Section 23M of the ITA (thin capitalization rule).

⁸⁰ Section 8F and 8FA of the ITA.

insufficient facts to conclude that the full deduction of the interest incurred by the South African subsidiary (Subco B) would be denied.⁸¹

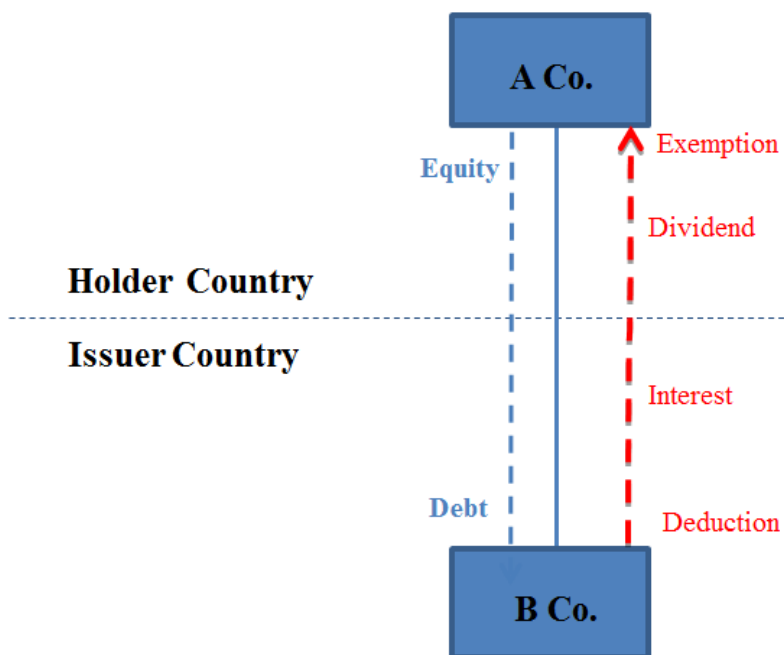
3.3.2.2 Deduction/ non-inclusion (II)⁸²

The following assumptions were made under the second case triggering deduction in one country with non-inclusion in another:

- (i) a hybrid instrument that is treated as debt for tax purposes by the issuer's jurisdiction and as equity for tax purposes by the holder's jurisdiction;
- (ii) the issuer deducts the interest payments on the instrument for purposes of its home jurisdiction;
- (iii) the holder, receives income, qualified as dividend, that, pursuant to a participation exemption regime is not taxable in the country of the holder. Similar effects could also be reached under an imputation system as the income associated with the dividend on the instrument is sheltered by a tax credit.

The desired result of this scheme is to deduct interest in the issuer Country and not include the interest as taxable income in the holder Country.

Diagram IV: Deduction/non-inclusion (II)



Scenario A: Issuer Country is the surveyed country

All surveyed countries' reports suggest that their countries could be involved in such a scheme as issuer Country with the desired effects of deduction with non-inclusion, since the deduction in their countries will be possible, while non-inclusion in a foreign country (holder Country) is assumed.

⁸¹ See South Africa report at 17.

⁸² Cf. "deduction/non-inclusion" with hybrid entity example in OECD (2012), *supra* n. 23, paragraphs 16-17 at pp. 8-9 and "Example 1.1". "See "interest payment under a debt/equity hybrid" in OECD (2015), *supra* n. 12, p. 175.

In order to achieve the anticipated result in Colombia, the financial instrument should be carefully drafted to avoid a reclassification of dividends and interest under transfer pricing provisions, i.e. the loan contract should be drafted under terms complying with the arm's length principle.⁸³

The Brazilian reporters underline that the scheme can be effective especially because of the fact that in Brazil the payment of interest on net equity (“juros sobre o capital próprio”, “JCP”) is treated as interest that constitutes a tax deductible expense, while other jurisdictions tend to regard it as dividends, since its payment is based on equity investment,⁸⁴ which may fall within the participation exemption.⁸⁵ Moreover, deduction with non-inclusion is also possible as a result of the tax/accounting mismatch regarding debt and equity instruments. The Brazilian tax law stipulates that expenses incurred in connection with debt instruments are deductible, even in the case where such debt instrument is registered as equity for accounting purposes (e.g. perpetual bonds). Conversely, the remuneration from equity instruments is not subject to taxation (equity treatment), despite treatment as debt for accounting purposes (e.g. redeemable preferred shares).⁸⁶

It may initially be concluded that deduction in one country with non-inclusion in the other may be achieved in the Uruguayan case if the interest is sourced in Uruguay and the lender (holder of the hybrid instrument) is taxable, even if not effectively taxed, on the interest payments received from the Uruguayan issuer of the debt instrument.⁸⁷ However, the fact that the lender is eventually not effectively taxed on the income from payments received from Uruguay, due to their reclassification from interest into dividend and the applicability of the participation exemption, may change this outcome. Uruguayan tax law (“regla candado”) restricts the deductibility of interest paid by a Uruguay company to a foreign lender when the lender is not taxed on the interest received from Uruguay.

The case may be met with some success in South Africa if cumulatively: (i) the hybrid instrument issued by the South African company does not qualify as a “hybrid debt instrument”,⁸⁸ (ii) the interest thereon is not considered “hybrid interest” under South African tax law; (iii) and the proposed debt limitation rules of section 23M of the ITA (1962) would not operate to limit the deduction in South Africa.⁸⁹

Scenario B: Holder Country is the surveyed country

⁸³ See Colombia report at 10.

⁸⁴ For instance, the Spanish National Court (“Audiencia Nacional”) in its judgment of 27 February 2014 (Case No. 232/2011) classified Brazilian interest on net equity as dividend under Spanish domestic law, based on its typical characteristic of a corporate right. Similarly, the German Federal Court of Finance (“Bundesfinanzhof”) in its judgment of 6 June 2012 (Case No. 1 R 6/11) characterized Brazilian interest on net equity as dividend both under German domestic law and the Brazil-Germany tax treaty. See R. Tomazela, *Why Brazil's interest on net equity should not be affected by BEPS Action 2*, available online at: <http://www.kluwertaxlawblog.com/blog/2015/08/26/why-brazils-interest-on-net-equity-should-not-be-affected-by-beps-action-2/>.

⁸⁵ See Brazil report at 8.

⁸⁶ Id.

⁸⁷ See Uruguay report at 10.

⁸⁸ “Hybrid debt instrument” means “any instrument in respect of which a company owes an amount during a year of assessment if in terms of any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property”. See section 8F in conjunction with section 80L of the ITA.

⁸⁹ See South Africa report at 17-18.

For Brazil, Colombia and Uruguay this scheme would achieve the desired effects of deduction with non-inclusion where their countries act as the holder Country because their countries allow for non-inclusion, while deduction in a foreign country (issuer Country) is assumed.⁹⁰

By contrast, the envisaged scheme would be unlikely to succeed where South Africa was the holder Country in respect of full non-inclusion as a result of the participation exemption, because of one of the following reasons:⁹¹ (i) the amount in question is not treated as a dividend in the country of issue;⁹² (ii) the amount in question is deductible in the country of issue (a form of linking rule);⁹³ or (iii) the amount is not payable in respect of an “equity share” as defined in section 1 of the Act (further proviso to section 10B of the ITA).⁹⁴

3.3.2.3 Deduction/ non-inclusion (III)

The following assumptions were made under the third case triggering deduction in one country with non-inclusion in the other:

- (i) a parent holds a subsidiary that is a hybrid entity. The subsidiary is treated as a separate corporation from the perspective of the Country of residence of its parent and as a transparent entity in its own Country of residence;
- (ii) the parent borrows money from the subsidiary, i.e. the subsidiary is the holder of the debt;
- (iii) the parent deducts the interest on the debt;
- (iv) the subsidiary does not include the interest in its income.

Diagram V: Deduction/non-inclusion (III)

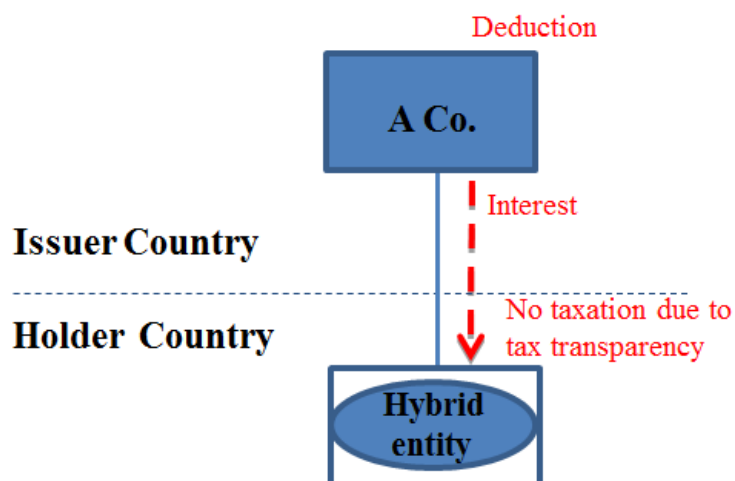
⁹⁰ See Brazil report at 8; Colombia report at 10; and Uruguay report at 10.

⁹¹ See South Africa report at 18.

⁹² Section 10B(2) of the ITA read with the definition of “foreign dividend” in section 1 of the ITA.

⁹³ Proviso to section 10B of the ITA.

⁹⁴ An “equity share” means “any share in a company excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in the distribution.”



Scenario A: Holder of the debt (the subsidiary) is resident in the surveyed Country

The reporters of all surveyed countries, apart from an unlikely scenario in South Africa, said that their countries could not be involved in such scheme as Country of the debt's holder (Country of the subsidiary).⁹⁵ It stems from the lack of tax provisions allowing for a tax transparent treatment of a domestic company in the said countries.

In South Africa this scheme would only be successful if the subsidiary were classified as either a partnership or a branch of the parent entity. As both such entities are tax transparent for South African tax purposes, the income on the note would not comprise an amount received or accrued by such partnership or branch and accordingly would not be subject to tax in South Africa.⁹⁶ Furthermore, if the partnership or the branch constituted a PE, profits of which could be taxed in South Africa, the PE would recognize interest income (if considered attributable to the PE) in this scenario rendering it inapplicable.

Scenario B: Issuer of the debt (the parent) is resident of the surveyed Country

In this scenario, the reporters of Brazil and Colombia concluded that this scheme could work in their jurisdictions, while the opposite was said by the reporters of South Africa and Uruguay.⁹⁷

While the scheme could bring the desired outcome of deduction with non-inclusion in Brazil, the possibility exists that the success may be limited by the Brazilian transfer pricing and thin capitalization provisions. Furthermore, on application of the Brazilian CFC rules by tax authorities, the interest income of the subsidiary would be subject to Brazilian taxation at the current basis, thus reducing the appeal of the scheme. The Colombian reporter did not note any risks with this scheme and, in the absence of any CFC rules in force, the interest income earned by the subsidiary would not be taxed in Colombia.

⁹⁵ See Brazil report at 9; Colombia report at 11; South Africa report at 19; and Uruguay report at 11.

⁹⁶ See South Africa report at 18.

⁹⁷ See Brazil report at 9; Colombia report at 11; South Africa report at 18; and Uruguay report at 11.

In Uruguay the scheme will not achieve anticipated results because the interest payments made by the Uruguayan parent will not be deductible due to the lack of their taxation in the country of the recipient (a form of linking rule).

The scheme fails in South Africa because the foreign subsidiary would be considered a “foreign partnership”. Such classification would result in the subsidiary being treated as tax transparent for South African tax law purposes. The South African parent would therefore not be able to deduct the interest on the loan to the extent of its share of the partnership.

3.3.2.4 Interim conclusions in respect to the effectiveness of deduction with no inclusion schemes

To summarise this results from the case studies focussing on deduction in one country with no inclusion of income in the other country: in case (I) Scenario A, the scheme could not achieve the desired result in any of the surveyed countries, apart from South Africa. The lack of success is generally attributable to the general tax law provisions in each of the countries. However, in Scenario B, the scheme may be successful in both Brazil and Colombia because of the lack of anti-hybrid rules. This scheme will not be successful in South Africa and Uruguay, however, since the former country may apply its anti-hybrid rules, while the latter country relies on a general rule (“regla candado”) that interest payments made by a Uruguayan company are not deductible if they do not constitute taxable income for the lender.

For case (II) Scenario A, successful application of such a scheme was possible in Brazil, Colombia, and Uruguay due to the lack of anti-hybrid rules. The successful outcome in Brazil is assisted further by rules stipulating that a payment of interest on net equity is tax deductible. However, from a tax policy point of view, the Brazilian tax provisions regulating interest on net equity should not be perceived as facilitating tax avoidance via hybrid mismatches. These rules mainly constitute a legal mechanism created by the Brazilian legislator to achieve tax policy objectives important for economic growth in Brazil.⁹⁸ In South Africa, the effect of the scheme could be struck down either by anti-hybrid debt instrument rules or under the debt limitation rules of section 23M of the ITA (1962). Similarly for Scenario B the scheme could be effective in Brazil, Colombia, and Uruguay because anti-hybrid rules do not exist or cannot be applied. In South Africa, the anti-hybrid rules may prevent the scheme from being successful.

Finally, case (III) in Scenario A was unlikely to apply in any of the surveyed countries. In a limited application, the scheme could yield a positive outcome in South Africa, should the entity qualify as a partnership. As a partnership is tax transparent, its income would not comprise an amount received or accrued by the partnership, which is critical to cause the desired result of deduction with non-inclusion. For Scenario B, the scheme can be effective in Brazil and Colombia, again due to the lack of anti-hybrid rules. It will not be effective in relation to Uruguay, since interest is not deductible at the level of the Uruguayan

⁹⁸ It regards “the following tax policy objectives: (i) to mitigate the effects of the distinction between equity and debt, thus reducing the debt bias; (ii) to encourage the capitalization of Brazilian companies through formal capital contribution, in order to prevent leveraging and excessive level of indebtedness; (iii) to integrate corporate and individual income taxes, for the purposes of eliminating double taxation of corporate profits; (iv) to alleviate the undesirable effects of the prohibition on monetary adjustment of financial statements in a context of high inflation.” See Tomazela, R., *Why Brazil's interest on net equity should not be affected by BEPS Action 2*, available online at: <http://www.kluwertaxlawblog.com/blog/2015/08/26/why-brazils-interest-on-net-equity-should-not-be-affected-by-beps-action-2/>.

company whenever it is paid to an entity that is not taxable on such payments. In the case of South Africa, the lack of the said effectiveness stems from the general tax treatment of income derived by South African companies via foreign partnerships and interest incurred by such partnerships.⁹⁹

3.3.3 Tax arbitrage via hybrid mismatches: country perspectives

3.3.3.1 Illustrative tax arbitrage via hybrid mismatches exposed in the surveyed countries

Apart from two publicized transactions in Colombia, there have been no decided or publicly exposed cases in the other surveyed countries concerning tax arbitrage via hybrid mismatches.¹⁰⁰ (The first Colombian transaction considered the sale of the largest brewery in Colombia (Bavaria) from the Colombian family (Santo Domingo) to South African SABMiller. The sale was achieved through the use of a hybrid entity and a hybrid transfer, i.e. a transfer that is treated as a sale for the purposes of one jurisdiction while it is not treated as a sale for the other jurisdiction. The Santo Domingo Group contributed their shares in Bavaria (the Colombian target) to a Delaware LLC (BevCo Sub LLC), as part of a plan for a merger with Racetrack LLC, a Special Purpose Vehicle (SPV) owned by SABMiller. The BevCo Sub LLC was a hybrid entity, as it made the election to be treated as a partnership under US check-the-box rules. After the Santo Domingo interest in Bavaria had been transferred to BevCo Sub LLC, Racetrack LLC absorbed BevCo Sub LLC in a forward triangular merger. For Colombian purposes, the whole transaction including the contribution of shares to BevCo Sub LLC was viewed as a merger, while the US viewed the contribution as a taxable contribution. The US classification allowed for a step-up in the basis (costs) of Bavaria shares for the buyer (Racetrack LLC owned by SABMiller). While politicians and the media denounced that no taxes had been paid and requested that the transaction be treated as a sale, the same effect could have been achieved by other means. At the time of the transaction, the Santo Domingo Group shares in Bavaria could have been transferred at book value to a foreign company without tax consequences. Therefore, even if the transaction was treated as a sale, the taxable income would have remained zero despite the transaction value being USD 4 billion.

Despite public outcry over the lack of taxation in Colombia (led in in 2007 by a Congressman) the transaction was confirmed to have not violated any laws in Colombia. Furthermore, since the merger took place outside of Colombia, taxation in Colombia was precluded due to the territoriality principle. Legislative amendments followed (motivated in part by this transaction) requiring that the transfer of assets to a foreign jurisdiction was to take place at arm's length in terms of the transfer pricing rules effectively triggering an exit tax in Colombia.

The second publicized transaction in Colombia concerned a mining company resident in Switzerland. This company (the parent company) started a tax planning scheme to take advantage of a hybrid mismatch. The parent company in Switzerland formed a company in a tax haven (the tax haven company) funded with USD 1000. The tax haven company then obtained a loan for over 1 million USD, which was to be loaned to the Colombian subsidiary of the Swiss company (also its parent company). The interest to be received by the tax

⁹⁹ The South African parent will not be able to deduct the interest on the loan to the extent of its share of the partnership.

¹⁰⁰ See Brazil report at 10; Colombia report at 11-12; South Africa report at 219; and Uruguay report at 11.

haven company would be exempt in the tax haven and the Colombian highly profitable subsidiary would claim an interest deduction, reducing its corporate income tax in Colombia. This scheme would have achieved the aim of deduction in one jurisdiction with non-inclusion in another. The tax haven company was classified as a hybrid entity in that jurisdiction (this is how the tax haven could obtain the loan with such small equity as the loan was made with reference to the assets of the parent company), but as opaque by the parent company in Switzerland. The interest was therefore not taxed in Switzerland.

When the Colombian company attempted to register the foreign debt with the Central Bank, the head of the tax administration was made aware. The tax administration director appeared in the media stating that this was a case of gross tax avoidance, and presented the case as an example to justify the existence of the Colombian GAAR. The Colombian company withdrew the application for the registration of the debt and the parent company in Switzerland liquidated the company in the tax haven.

3.3.3.2 Hypothetical tax arbitrage via hybrid mismatches schemes in the surveyed countries

All reporters depicted schemes of tax arbitrage via hybrid mismatches that potentially could take place in their countries.¹⁰¹

Two schemes were suggested in the Brazilian report. The first involves the use of Austrian debentures and utilising the Brazil-Austria tax treaty. Under this treaty, dividends paid from Austria to a Brazilian company are exempt from taxation in Brazil if the Brazilian company owns at least 25 percent of the share capital of the Austrian company paying the dividend (the participation exemption).¹⁰² Furthermore, Art. 10(4) of the Brazil-Austria tax treaty includes in the meaning of “income from dividends” “jouissance” shares or “jouissance” rights. According to Austrian law, some “jouissance” shares or “jouissance” rights are treated as debt for domestic purposes, for example debentures, thus qualifying as a deductible expense. Consequently, where a Brazilian company which has more than 25 percent of the shares in an Austrian company and receives dividends from debentures in Austria, a deduction in Austria with non-inclusion in Brazil arises.

The second suggested scheme involves interest on net equity and utilization of discrepancies between tax and accounting treatment of financial instruments.¹⁰³ This scheme also achieves the deduction with non-inclusion outcome.

The Colombian reporter indicated a possible scheme which, through the use of deep-in-the-money share options, to have the transaction treated as a sale in a foreign jurisdiction (mostly in US and some countries in Europe) without triggering the exit tax in Colombia. The person holding a deep-in-the-money option in the foreign country would be treated as owning the underlying shares, while Colombia would only see a sale (with the corresponding tax) when the holder exercises the right granted by the option causing the hybrid mismatch. Only if there are no benefits other than tax benefits in the granting of the option on the Colombian shares could this scheme be considered as tax avoidance that may trigger an application of the Colombian

¹⁰¹ See Brazil report at 10; Colombia report at 12; South Africa report at 22; and Uruguay report at 11.

¹⁰² See Art. 23(2) Brazil-Austria tax treaty.

¹⁰³ Cf. section 3.3.2.2 above in Scenario A.

GAAR. Another hybrid mismatch arrangement makes use of the differences in the qualification of leasing contracts. The lease payments can be fully deducted in the lessee's country of residence, Colombia, without excluding the portion attributable to capital. The lessor who is resident in State A only includes the interest portion as income in State A.

In Uruguay dividends received by a Uruguayan company from foreign companies will not be taxed in Uruguay due to the fact that they constitute income of a foreign source. Provided that such dividends are treated as interest deductible in countries from which they are paid to the Uruguayan company, the scheme may lead to deduction with non-inclusion.

In South Africa, where a South African resident taxpayer holds a debt instrument issued by a non-resident and the legal form of this instrument is a debt according to the law of a non-resident state but treated as equity under South African law and therefore the instrument qualifies as a hybrid debt instrument the South African resident is deemed to accrue a dividend in *specie* instead of interest. This income then qualifies as exempt income in the hands of the holder (the South African resident), while potentially remaining available as a deduction in the hands of the recipient (the non-resident). Accordingly, the scheme brings deduction with non-inclusion.

3.3.3.3 Differences between tax arbitrage via hybrid mismatches carried out by multinational corporations and high net worth individuals in the surveyed countries

The reporter of Uruguay indicated that there are no differences between tax arbitrage via hybrid mismatches carried out by multinational corporations and high net worth individuals in that country.¹⁰⁴ Likewise for the Brazilian reporters. Albeit in the Brazilian report it is indicated that some differences may appear because of the fact that the Brazilian CFC rules are only applicable to companies.¹⁰⁵ Thus hybrid mismatch schemes involving Brazilian individuals can bring more effective results than those with Brazilian companies. The same can be said in relation to Uruguayan companies, since the Uruguay CFC rules are only applicable to Uruguayan individuals.¹⁰⁶

For both South Africa¹⁰⁷ and Colombia, there is lack of information to stratify the taxpayers currently involved in tax arbitrage via hybrid mismatches. The Colombian reporter, however, interestingly said that there is certainly a higher chance of large multinationals being audited than high net worth individuals, as the additional reporting obligations required from multinationals make it easier for the tax administration to discover arbitrage when Colombia is the residence state.¹⁰⁸ This finding implies that even though there is a lack of data allowing for determining differences between tax arbitrage via hybrid mismatches carried out by Colombian multinational corporations and high net worth individuals, it is more likely that such arbitrage will be detected in future in relation to companies rather than to individuals. This leads us to a general conclusion that neutralizing effects of hybrid mismatches seems to be more effective with respect to

¹⁰⁴ See Uruguay report at 11.

¹⁰⁵ See Brazil report at 10.

¹⁰⁶ The South African CFC rules may not cause the said difference, since they apply to both South African individuals and companies. In Colombia, in turn, there are no CFC rules in force.

¹⁰⁷ See South Africa report at 22.

¹⁰⁸ See Colombia report at 12.

companies than individuals, because there are generally more reporting obligations stemming from tax rules for companies in comparison to individuals.

3.3.3.4 Revenue effects of tax arbitrage via hybrid mismatches on tax systems of the surveyed countries

Reporters of all the surveyed countries said that they are not aware of any data measuring the impact of tax arbitrage via hybrid mismatches on revenue effects in their countries.¹⁰⁹ Regardless of the perceived importance of the issue of hybrid mismatches in each of the countries, no measure of the impact of tax arbitrage via hybrid mismatches on revenue has been publicly disclosed. In any event, measurement of this nature may be very difficult to accurately determine both for the countries in this study and in general.¹¹⁰

3.4 Current and prospective domestic and tax treaty provisions and practice against tax arbitrage via hybrid mismatches

3.4.1 Domestic anti-hybrid rules and other provisions relevant to prevent tax arbitrage via hybrid mismatches

Legislative intervention to prevent hybrid mismatches varies across the countries surveyed ranging from the most in South Africa, less in Uruguay and Colombia, and least in Brazil.¹¹¹ Only the South African legislation embeds explicit restrictions to tax arbitrage via hybrid mismatches. The analysis of the domestic anti-hybrid rules begins, therefore, with this country's legislation.

According to the South African reporter, the following tax law provisions are considered to explicitly target tax arbitrage via hybrid mismatches: (i) sections 8E, 8EA, 8F and 8FA of the ITA (1962) concerning hybrid instruments; (ii) proviso to section 10B of the ITA (1962) stipulating that the participation exemption does not apply to foreign dividends which can be deducted for tax purposes in a foreign jurisdiction; (iii) paragraph 80 of the 8th Schedule to the ITA (1962) regulating exemption from capital gains vested by a trust; (iv) section 1 of the ITA (1962) stating that "any person other than a natural person" is not resident of South Africa if the person is a resident of another county in terms of any tax treaty ratified by South Africa; (iv) provisions excluding "foreign partnerships" as defined from the scope of taxable "companies"¹¹² and section 24J(1) of the ITA (1962) allowing for treatment of repurchase agreements and resale agreements as interest bearing financial arrangements. Moreover, sections 8F, 8FA, 24J of the ITA (1962) (in respect of resale agreements) and the definition of "company" and "person" (in respect of "foreign partnerships") operate as re-characterisation provisions. Substance over form would appear to be the main driver of the re-characterisation provisions of section 8E, 8EA, 8F and 8FA, while linkage would appear to be the main driver of the denial of the application of participation exemption to foreign dividends which are treated as tax deductible expenses in the foreign jurisdiction.

¹⁰⁹ See Brazil report at 12; Colombia report at 14; South Africa report at 27; and Uruguay report at 13.

¹¹⁰ See *infra* part 3.

¹¹¹ See Brazil report at 11; Colombia report at 12; South Africa report at 22-24; and Uruguay report at 12.

¹¹² They are therefore treated as transparent for these purposes, see J. Hattingh, *South Africa – Corporate Taxation*, IBFD Tax Research Platform, at 1.1.4.

In Uruguay the tax provision stipulating that only interest constituting taxable income for the taxpayer receiving the interest is deductible (law 18,083, “regla candado”), may be perceived as an anti-hybrid rule. The reporter also states that the Uruguayan CFC rules,¹¹³ GAAR including a substance over form approach, and the restrictions on the deduction of expenses providing that only the necessary expenses properly documented can be tax deductible, may be considered as having an impact on tax arbitrage through hybrid mismatches. The territorial tax system of Uruguay has similar impact since interest paid by a foreign branch of a Uruguayan company is not deductible in Uruguay, i.e. income of that branch is not included in the tax return of the Uruguayan company, but equally neither are the expenses of that. Beyond that, there are neither re-characterisation provisions nor provisions specifically dealing with cross-border tax arbitrage via hybrid mismatches.

In Colombia the transfer pricing provisions and the GAAR can target tax arbitrage through hybrid mismatches. The transfer pricing provisions are also considered re-characterisation provisions, since they allow the Colombian tax authorities to re-characterise interest into dividends. The effect is that any deduction will be denied whenever interest transactions are deemed as non-compliant with arm’s length conditions (a form of thin capitalization rule). In any case, however, neither transfer pricing provisions nor the GAAR are specifically aimed against cross-border tax arbitrage via hybrid mismatches.

Finally, the Brazilian reporters indicated that irrespective of the lack of a GAAR and specific anti-hybrid rules in the Brazilian tax law, the thin capitalization rules, limiting the interest deductibility to a debt-equity threshold of 2:1 debt-equity, can affect tax arbitrage via hybrid mismatches. Furthermore, the Administrative Board of Tax Appeals applies the business purpose doctrine to analyse whether tax planning structures are valid. In a case of hybrid mismatches, though, the reporters believed that more relevant than the business purpose doctrine is the doctrine of substance over form. That seems to be the underlying rationale in the *Colgate* case.¹¹⁴ The Brazilian reporters added that although CFC rules are applied in specific situations in most countries as anti-tax avoidance rules, in Brazil the CFC rules are applicable to all foreign investment held by Brazilian companies. These rules are therefore not seen as an anti-tax avoidance control from a Brazilian perspective, but as integral to the Brazilian Income Tax system. In any case, the currently worded CFC rules in Brazil can prevent tax arbitrage via hybrid mismatches regarding the use of foreign branches by their Brazilian head offices.¹¹⁵

¹¹³ According to these rules, resident individuals obtaining income from dividends, interest and all income derived from capital factor generated abroad via a CFC, the income will be taxed at the level of the individual, i.e. a separate tax personality of a CFC is disregarded. Therefore these rules are called in Uruguay “fiscal transparency rules” (*reglas de transparencia fiscal*).

¹¹⁴ See Decision of August 24 2009, Case No. 9101-00.287.

¹¹⁵ The Brazilian CFC rules allow to attribute an income of a foreign branch to its Brazilian head office, while the interest expense of that branch cannot be deducted from the Brazilian head office’s income (i.e. head office is taxed for the gross income of the PE). These rules therefore permit to prevent double deductions and deduction with no inclusion in said cases. Cf. *supra* 3.3.1.1 and 3.3.1.3.

3.4.1.1 Tax inspector guidelines/rulings and administrative rulings as opportunity for arbitrage

The reporters of all surveyed countries admitted that even if it may be potentially possible that tax rulings or administrative guidelines can create opportunities for tax arbitrage via hybrid mismatches, none of the reporters were aware of such rulings or guidelines.¹¹⁶

Interestingly, even in South Africa, where the perception of tax arbitrage through hybrid entities is high and certain anti-hybrid rules are in force, no guidelines and only one Binding Private Ruling has since been issued by the South African Revenue Service.¹¹⁷ One may assume that even tax authorities applying anti-hybrid rules are not aware of the structure and reasons for the functioning of hybrid arrangements to an extent sufficient to prepare an adequate and clear guideline on this issue.¹¹⁸

3.4.1.2 Current and rejected proposals for anti-hybrid rules

The reports of all surveyed countries show that there are no current proposals aimed at countering tax arbitrage via hybrid mismatches that are likely to be approved in the near future.¹¹⁹ The Colombian tax administration is reported to be unaware of the tax avoidance possibilities stemming from hybrid mismatches in most cases. In South African and Uruguay no successful attempts to counteract the such mismatches have been taken. Lastly, in Brazil, the debate to repeal the deductibility of interest on net equity's provisions was unsuccessful.

3.4.1.3 Tax treaty provisions countering tax arbitrage via hybrid mismatches

None of the reports mention the existence of tax treaty provisions that could counter tax arbitrage via hybrid mismatches explicitly,¹²⁰ but some do impact such mismatches implicitly.

For Brazil, the interest on net equity's provision under the interest article of some Brazilian tax treaties may implicitly have the effect, in the residence state, of preventing the classification of interest as dividends.¹²¹

¹¹⁶ See Brazil report at 11; Colombia report at 13; South Africa report at 24; and Uruguay report at 12.

¹¹⁷ 1 of March 2016, BPR 225. This ruling determines the dividends tax consequences for a non-resident issuer of hybrid debt instruments. The ruling as available online at: <http://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BPR-2016-10%20-%20BPR225%20Hybrid%20debt%20instruments.pdf>.

¹¹⁸ In that regard, the German experience with its anti-hybrid rule on dual consolidated losses is instructive, i.e. the German Dual Consolidated Loss Rule of section 14 No. 5 of the German Corporate Tax Act (*Körperschaftsteuergesetz*), version dated 15 October 2002, BGBl. I 2002 at 4144, last amended 2 November 2015, BGBl. I 2015 at 1834, see A. Perdelwitz, *Germany - Corporate Taxation - Country Analyses*, IBFD Tax Research Platform, Last Reviewed: 9 December 2016, p. 15. This rule says that "Losses of a controlling entity or a controlled entity in a German tax consolidated group are disallowed for German tax purposes to the extent such losses are taken into account for foreign tax purposes at the level of the controlling entity, the controlled entity or any other person." [translation after: Deloitte, *Scope of dual consolidated loss rules broadened*, Germany Tax Alert, 13 March, 2013, available online at: <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtli-tax-alert-germany-110313.pdf>]. Although this rule was for the first time introduced to the German tax law with effect from 2001, it had reportedly never been applied by the German tax administration. From the beginning there was a lack of clarity about the rule's potential content. The tax administration for more than ten years had neither managed to issue any explanatory guideline on its application nor provided a box for an entry in the official tax return forms. See J. Lüdicke, *The BEPS Work on Hybrid Mismatches – Selected Issues* in R. Danon (ed.), *Base Erosion and Profit Shifting (BEPS): The Impact for European and international tax policy*, (Schulthess: 2016), pp. 54-56. Regardless of this perceived flaw in potential application of this anti-hybrid rule, the OECD mentioned this rule in the 2012 Report on Hybrid Mismatch Arrangements as one of the few examples of an anti-hybrid rule existing currently in the legislation of the OECD Member State. This implies that without even briefly indicating the lack of its application in Germany and the lack of clarity of its content, the OECD recommends other countries to consider following the German example. See OECD (2012), *supra* n. 23, paragraph 39 at p. 15,

¹¹⁹ See Brazil report at 12; Colombia report at 13-14; South Africa report at 24-25; and Uruguay report at 12.

¹²⁰ See Brazil report at 12; Colombia report at 14; South Africa report at 25-26; and Uruguay report at 12.

¹²¹ In fact, the interest on net equity provision is included usually in the protocols to some of the Brazilian tax treaties, which constitute parts of the previously concluded treaties, e.g. they modify/supplement the equivalents of Article 11 (interest) OECD MC of the Brazilian

However, such provision in the treaty may have “no effect”¹²² over the domestic law of the residence state which seems to be the case based on the interpretation of, for example, the Brazil-Netherlands tax treaty. Moreover, the Brazilian treaty network typically includes a provision according to which the treatment under the interest article should be similar to the treatment given by the domestic law of the state of source (i.e. the state from which the interest is paid out).¹²³ This may reduce the opportunities for using hybrid mismatches resulting in deduction with non-inclusion. In such cases the treatment of payments in the source state as interest will trigger the analogous treatment of such payments in the state of residence of their recipients, preventing the application of the participation exemption for these payments (provided that the exemption under domestic laws applies exclusively to dividends and that the treaty qualification is binding for domestic purposes).

In Colombian tax treaties the only provision that may potentially affect tax arbitrage via hybrid mismatches is the “main business purpose” provision within the LOB clauses.

The reporter of Uruguay indicates that only beneficial ownership clauses of treaty provisions are likely to be applied against tax arbitrage through hybrid mismatches. Whereas in South Africa, treaties stipulating that instances of dual residence for persons other than individuals¹²⁴ shall be resolved by mutual agreement may be a limiting factor to mismatches.

3.4.1.4 Penalties for tax arbitrage via hybrid mismatches

In Uruguay¹²⁵ and Colombia, until 2015, no penalties have been in force. However, in Colombia since 2015, the Minister of Finance announced that he intends to introduce criminal liability for tax avoidance. This tax reform was postponed until the third quarter of 2016 and even if approved will only enter into force in 2017.

In Brazil, penalties may be imposed on taxpayers if the tax authorities disagree with the interpretation of tax law applied by taxpayers that result in avoiding taxation. This means that if the tax authorities challenge a tax benefit arising from hybrid mismatches, penalties will be charged in addition to the principal amount. By contrast, in a case in which it is decided that the tax planning involving a hybrid arrangement is valid, no penalty applies.

treaties. These additional protocols expressly indicate that the interest on net equity constitutes interest under Article 11(2), see, for example, Article 1 (a.2(b)) of the Protocol regulated by the Treasury Ministry Ordinance 28 of 2002 to the treaty with Portugal (2000); Article 1 (a.2(b)) of the Protocol regulated by Treasury Ministry Ordinance 285 of 2003 to the treaty with Chile (2001); and Article 1 (2) of the Protocol regulated by Treasury Ministry Ordinance 38 of 2007 to the treaty with Mexico (2003). In general, the treaties concluded by Brazil before 1990 adopt the definition of interest found in the 1967 OECD MC, which extends the definition of interest as referred by the domestic legislation of the source country, see, for example, Article 10(4) of the treaty with Japan (1967) and Article 11 of the treaty with Austria (1976). This means the under such treaties the interest on net equity qualifies as interest in so far Brazil is the source country of the interest.

¹²² By “no effect” Brazilian reporters mean that interest and dividends are subject to the same tax burden in the residence state. Interest on Net Equity (“INE”) is a hybrid instrument in the sense that it is treated for tax purposes as interest in some countries (e.g. Brazil) and as dividend in other countries. Accordingly, in the Brazilian report we mean by “effect” a beneficial tax treatment on foreign dividends in comparison to the tax treatment of foreign interest received from Brazil. Specifically in regards to the Brazil-Netherlands tax treaty, it is stated that this provision may have no effect if the Dutch tax burden is the same on foreign dividends and interest.

¹²³ It reflects the Avery Jones’s approach called “the new approach” and currently applying mostly in the field of solving problems of qualification conflicts under distributive rules. See to this effect J. F. Avery Jones, et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model—I*, British Tax Review 1 (1984), p. 50; J-M, Déry and D. Ward, *Canada in Interpretation of Double Taxation Conventions*, (IFA Cahiers Vol. 78a, 1993), p. 281, Online Books IBFD. See Commentary on Article 23 A and B, paragraphs 32.1-32.3.

¹²⁴ And in case of the treaties with Bulgaria, Canada, and US, in case of persons other than individuals and companies.

¹²⁵ See Uruguay report at 13.

Finally, the South African reporter indicated that taxpayers involved in a hybrid arrangement will not be subject to penalties if they fully and properly disclose this arrangement, unless it results in an understatement¹²⁶ of South African taxes. It means that penalties can be imposed on a taxpayer only if the outcome of a hybrid mismatch arrangement results either from tax evasion or understatement.

3.5 Current and potential reaction of the surveyed countries to OECD inputs within the BEPS Project

Even though none of the surveyed countries is (yet) a member of the OECD, they do cooperate with the OECD although to different extents.¹²⁷ Thus the OECDs inputs may influence shaping their tax systems, including issues related to tax arbitrage via hybrid mismatches. The reactions to these inputs, however, vary among the countries.

Brazil and South Africa participate in the BEPS Project through their membership of the G20 and being a signatories to the Declaration on Base Erosion and Profit Shifting as adopted at a meeting of the OECD Council at Ministerial Level on 29-30 May 2013.¹²⁸

In May 2013, the OECD Council launched accession discussions with Colombia and this country is currently completing the proceedings to become an official member of the OECD. This country is also a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes, the OECD's Committee on Fiscal Affairs (CFA), and BEPS' Working Party 6.¹²⁹

¹²⁶ An understatement of South African taxes means: "any prejudice to SARS or the fiscus as a result of (i) a default in rendering a return; (ii) an omission from a return; (iii) an incorrect statement in a return; or (iv) if no return is required, the failure to pay the correct amount of 'tax.'" See section 221 of the Tax Administration Act 2011 (Act No. 28 of 2011).

¹²⁷ Brazil and Colombia are also member of the Inter-American Center of Tax Administrations (*Centro Interamericano de Administraciones Tributarias*, "CIAT"). However, in the opinion of the reporters, this forum is extremely hermetic and therefore there is no information available on whether tax arbitrage via hybrid mismatches were dealt within its functioning.

¹²⁸ See this document online at: <http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=C/MIN%282013%2922/FINAL&docLanguage=En>. Brazil and South Africa are two among five of the so-called BRICS counties that were invited by the OECD in 2007 to introduce a strengthened cooperation through "Enhanced Engagement" programmes and therefore they are considered to be the Key Partners that contribute to the OECD's work in a sustained and comprehensive manner also in respect of other issues than the way tax authorities supervise their taxpayers. OECD, *Members and partners*, available online at: <http://www.oecd.org/about/membersandpartners/>. The enhanced cooperation between the OECD and BRICS counties is fully understandable and justified, since it is estimated that economies of the latter countries could overtake the combined GDP of the G7 nations by 2027. See R. Foroohar, *BRICs Overtake G7 By 2027*, Newsweek Business, available online at: <http://europe.newsweek.com/brics-overtake-g7-2027-76001?rm=eu>. BRIC is an acronym first used by Jim O'Neill in a 2001 paper entitled *Building Better Global Economic BRICSs*, Global Economics Paper No: 66, available online at: <http://www.goldmansachs.com/our-thinking/archive/archive-pdfs/build-better-brics.pdf>. BRIC refers to the countries of Brazil, Russia, India and China, which are all deemed to be at a similar stage of newly advanced economic development. This acronym has come into widespread use as a symbol of the shift in global economic power away from the developed G7 economies towards the developing world, see K. Beth, *For Mr. BRIC, nations meeting a milestone*, CNNMoney.com, available online at: http://money.cnn.com/2009/06/17/news/economy/goldman_sachs_jim_oneill_interview.fortune/index.htm. Since 14 April 2011 BRIC is to be known as BRICS due to the new membership of South Africa. See more online at: <http://www.southafrica.info/global/brics/brics-080411.htm#ixzz2elKqwksc>.

¹²⁹ Working Party 6 deals with Taxation of Multinational Enterprises in relation to part of Action 4 (Limit Base Erosion via Interest Deductions and Other Financial Payments), Actions 8 (Assure that Transfer Pricing Outcomes are in Line With Value Creation / Intangibles), 9 (Assure that Transfer Pricing Outcomes are in Line With Value Creation / Risks and Capital), 10 (Assure that Transfer Pricing Outcomes are in Line With Value Creation / Other High-Risk Transactions), and 13 (Re-examine Transfer Pricing Documentation). See OECD, *About Base Erosion and Profit Shifting (BEPS)*, available online at: <http://www.oecd.org/ctp/beps-about.htm>.

Although Uruguay is only a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes, this Forum significantly influences the tax policy of this country. It convinced Uruguay to sign several tax treaties and tax information exchange agreements (TIEAs) and soften bank secrecy privilege.¹³⁰

Of all surveyed countries, Brazil and South Africa would seem the most likely candidates to follow the BEPS's work regarding the neutralization of the outcome of hybrid arrangements.¹³¹ However, reports of Brazil and South Africa imply that these countries see more potential in neutralizing hybrid arrangements' outcomes via domestic law than via tax treaties,¹³² not least because amending the treaties would likely be a time consuming and lengthy process.¹³³ Moreover, all surveyed countries agreed that the ambulatory interpretation of tax treaties cannot be a proper solution for solving problems caused by tax arbitrage via hybrid mismatches¹³⁴ either because their courts do not use such interpretational approach, as in the case of Colombia,¹³⁵ or as it is far from clear whether or not the courts will use such interpretation, like in South Africa.¹³⁶

3.6 Policy Perspectives

3.6.1 The feasibility of the introduction of the OECD policy recommendations contained in the BEPS Action Plan 2 in the surveyed countries

The analysis of the policy perspectives of the surveyed developing countries towards the prevention of tax arbitrage via hybrid mismatches commences with reporting their views on the feasibility of the selected policy recommendations contained in the BEPS Action Plan 2. This regards the following three recommendations: (i) introduction of specific tax treaty provisions aimed at ensuring that hybrid instruments and entities (including dual resident entities) are not used to unduly obtain treaty benefits;¹³⁷ (ii) introduction of domestic law provisions aimed at preventing exemption or non-recognition for payments that are deductible by the payer;¹³⁸ and (iii) introduction of domestic law provisions aimed at denying a deduction for a payment that is also deductible in another jurisdiction.¹³⁹

3.6.1.1 Introduction of specific tax treaty provisions aimed at ensuring that hybrid instruments and entities (including dual resident entities) are not used to unduly obtain treaty benefits

The Brazilian reporters indicated that some provisions of the tax treaties ratified by Brazil, such as LOB clauses and anti-abuse clauses allowing tax authorities to deny treaty benefits stemming from Arts. 10, 11

¹³⁰ As of October 2015, Uruguay was rated by the Global Forum as largely compliant with the OECD standard for exchange of information on request (EOIR). See OECD, *Tax Transparency 2015 Report on Progress*, available online at: <http://www.oecd.org/tax/transparency/global-forum-annual-report-2015.pdf>, p. 15.

¹³¹ See, however, different levels of perception of tax arbitrage via hybrid mismatches in Brazil and South Africa *supra* 3.2, and different stage of developments of domestic tax law aimed against this phenomenon between these countries *supra* 3.4.1.

¹³² See Brazil report at 13 and South Africa Report at 28.

¹³³ In that regard, the Brazilian reporters cautioned that domestic anti-hybrid rules may be perceived as treaty override. See Brazil report at 13.

¹³⁴ See Brazil report at 13 and South Africa Report at 28.

¹³⁵ See Colombia report at 15.

¹³⁶ See South Africa report at 28.

¹³⁷ I.e., the change to Art. 4(3) of the OECD MTC to solve the problem of dual resident entities in a way that cases of dual treaty residence would be solved on a case-by-case basis by tax authorities of contracting states upon the mutual agreement rather than on the basis of the current rule based on place of effective management of entities. See (OECD 2015), *supra* n. 12, pp. 137-138.

¹³⁸ *Id.*, pp. 23-65 and 83-91.

¹³⁹ *Id.*, pp. 66-82.

and 12,¹⁴⁰ can potentially be applied to ensure that hybrid instruments are not used to unduly obtain treaty benefits.¹⁴¹ They added, however, that such provisions do not seem to effectively target the issues at hand, since they are generic and have no clear interpretation. Therefore, the reporters suggest a bifurcated approach to deal with hybrid mismatches under tax treaties. This issue should be first addressed by domestic anti-hybrid rules, since most hybrid mismatches arise from the domestic laws of different countries, and then the treaties' provisions should be generic enough to allow the domestic anti-hybrid rules to apply. Secondly, in cases where the hybrid mismatches arise in connection with diverging interpretations of the treaty itself by the state of residence and the state of source, they suggested that Art. 3(2) MC OECD should be amended so that the interpretation of the state of source should prevail. This solution is already in force in the Brazilian tax treaties under the interest article¹⁴² and could be extended to all other distributive rules by the suggested change of equivalents of Art. 3(2) MC OECD in the Brazilian tax treaties.

The Colombian reporter pointed out that the first step to counter hybrid mismatches under tax treaties is to have a possibility to obtain clear information on the treatment of a transaction in the other contracting state.¹⁴³ Treaty provisions must therefore create an efficient, quick mechanism to request this information so that tax authorities of contracting states can decide on a case by case basis on whether the use of the treaty was legitimate or not. According to the reporter, this decision should be taken jointly, otherwise both countries will risk losing the effectiveness of their local tax incentives, even in cases of legitimate use. The reporter underlined that in the case of developing countries, such as Colombia, the joint decisions would also build expertise and will allow these countries to defend cases of legitimate use of preferential tax regimes or domestic tax incentives.

As tax treaties ratified by Uruguay already have provisions ensuring that hybrid instruments and entities are not used to unduly obtain treaty benefits, i.e. beneficial ownership clauses, the reporter felt that the protection, at least for Uruguay, was sufficient with respect to its treaties.¹⁴⁴

The South African reporter stated that South African tax treaty's provisions could be designed to ensure consistent application of the treaties in relation to hybrid entities. Specifically, the interest and dividend definitions under Articles 10-11 could be aligned with the domestic tax law characterisation (in the source state) applicable to hybrid instruments.¹⁴⁵ Such anti-hybrid rules included in tax treaties do not impose tax and it is therefore feasible to incorporate them in South Africa tax treaties.¹⁴⁶

¹⁴⁰ LOB's are found in the tax treaties concluded by Brazil in 2002 with: South Africa (Art. 28(2)); Israel (Art. 25); Mexico (Art. 28); Peru (Art. 27(2)); Trinidad & Tobago (Art. 28); Turkey (Art. 28); Ukraine (Art. 11(8)); and with Venezuela (Art. 28).

¹⁴¹ See Brazil report at 13-14.

¹⁴² See *supra* 3.4.1.3.

¹⁴³ See Colombia report at 15.

¹⁴⁴ See Uruguay report at 14.

¹⁴⁵ See South Africa report at 29.

¹⁴⁶ Under the South African tax law (section 108(1) and (2) of the ITA), confirmed by case law (see for example *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61 (8 MAY 2012), the tax treaties are incorporated into the domestic tax law in order to avoid double taxation and render reciprocal assistance in the administration and collection of taxes, merely allocating taxing rights – it is in fact common for all contracting states.

3.6.1.2 Introduction of domestic law provisions aimed at preventing exemption or non-recognition for payments that are deductible by the payer

While the Brazilian reports indicated that it is feasible to introduce to Brazilian domestic tax law provisions preventing exemption or non-recognition of payments that are deductible by the payer,¹⁴⁷ such provisions may raise issues regarding their compatibility with the non-discrimination provision of the Brazilian tax treaties because their application may lead to discriminatory situations between residents and non-residents.¹⁴⁸

In the view of the Brazilian reporters, provisions preventing exemption or non-recognition of payments that are deductible by the payer should be applied equally to cross-border and domestic situations to not give rise to discriminatory situations between residents and non-residents under the non-discrimination provision of the Brazilian tax treaties. Although ECJ case law does not apply to Brazil, the reporters raised the question of discrimination in the context of ECJ case law.¹⁴⁹ Applying domestic anti-hybrid rules equally to cross-border and domestic situations may not be an appropriate solution to avoid discriminatory situations between residents and non-residents based on this ECJ case law. As domestic provisions must be compatible with EU law, a consequence of using domestic provisions is that compatibility should be drawn from the provisions actual (*ipso facto*) rather than merely from formal (*ipso iure*) scope of application.¹⁵⁰ That is to say, if the domestic anti-hybrid rule typically applies only in cross-border scenarios then it can be seen as indirect discrimination of taxpayers investing via entities established outside their resident state against taxpayers investing via entities established in their resident state.¹⁵¹ In addition, preventing base erosion and profit shifting in an effective and comprehensive manner in domestic situations is difficult. As stated by AG Geelhoed, applying an anti-hybrid rule to a domestic situation causes a “considerable extra administrative burden for domestic companies and tax authorities, [it] is quite pointless and indeed counterproductive for economic efficiency [and is therefore] anathema to the internal market.”¹⁵² Prominent scholars express a similar critique with respect to domestic anti-avoidance provisions.¹⁵³

¹⁴⁷ See Brazil report at 14.

¹⁴⁸ One may, however, consider Rust's view that a linking rule aimed at preventing exemption or non-recognition for payments that are deductible by the payer does not seem to be inconsistent with the non-discrimination provisions contained in tax treaties (their equivalents of Article 24(4) OECD MTC). Article 24(4) OECD MTC prohibits all discriminations which are based on residence of the recipient of the payments, while a discrimination based on criteria other than residence is still permitted. Denying the deduction is not based on the residence of the enterprise receiving the payments, but rather that the payments are tax exempt at the level of the recipient company. Since criteria referring to residence and tax exemption are not identical, a domestic tax law provision preventing exemption or non-recognition of payments that are deductible by the payer does not violate Article 24(4) OECD MTC. Rust, *supra* n. 29, pp. 312, 318, and 324.

¹⁴⁹ See for example ECJ's judgments of 7 September 2004 in the *Manninen* case (C-319/02), ECR 2004, p. I-07477, paragraphs 46 and 53-54 and of 8 December 2011 in the *Banco Bilbao* case (C-157/10), ECR 2011, p. I-13023, paragraph 39.

¹⁵⁰ See ECJ's judgment of 14 October 1999 in the *Sandoz GmbH v Finanzlandesdirektion für Wien, Niederösterreich und Burgenland* case, C-439/97, ECR 1999, p. I-07041, paragraph 19 and Advocate General (AG) Ph. Léger's opinion on this case issued on 20 May 1999, ECR 1999, p. I-07041, paragraphs 31-48. See also ECJ's judgment of 8 July 1999 in the *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA v Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Économie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* case, C-254/97, ECR 1999, p. I-04809, paragraphs 12-13 and AG Saggio's opinion on this case issued on 1 December 1998, ECR 1999, p. I-04809, paragraph 7.

¹⁵¹ See B. J. M. Terra and P. J. Wattel, *European Tax Law*, 6th edition, Alphen aan den Rijn: Wolters Kluwer Law & Business, 2012, p. 219; A. Zalasiński, *Zakaz dyskryminacji w sferze podatków bezpośrednich w prawie podatkowym Wspólnoty Europejskiej*, Warsaw: C.H. Beck, 2006, pp. 191-193; B. Kuźniacki, *Komentarz do wyroku TS z dnia 8 lipca 1999 r. w sprawie C-254/97 Société Baxter i inni v. Premier Ministre i inni*, ECR 1999, s. I-4809 in W. Nykiel and A. Zalasiński (eds.), *Orzecznictwo Trybunału Sprawiedliwości Unii Europejskiej w sprawach podatkowych. Komentarz*, Warsaw: Wolters Kluwer, 2014, pp. 168-178.

¹⁵² See UK: AG Geelhoed's opinion 29 June 2006, Case C- 524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, [2007] ECR I-2112, paragraph 68.

¹⁵³ See W. Schön, *Taxing Multinationals in Europe*, Working Paper of the Max Planck Institute for Tax Law and Public Finance 11 (2012), p. 19; D. Smit, *EU freedoms, non EU-countries and Company Taxation*, EUCOTAX Series on European Taxation, Alphen aan den Rijn: Wolters Kluwer Law & Business (2012), p. 245; G. Maisto and P. Pistone, *A European Model for Member States' Legislation on the Taxation of Controlled Foreign Subsidiaries (CFCs) – Part 1*, 48 Eur. Taxn. 10 (2008), pp. 508-509; D. Weber, *Tax Avoidance*

The application of domestic law provisions aimed at preventing exemption for or non-recognition of payments that are deductible by the payer raises issues of practicability in Brazil. That an application of the proposed provisions would require the taxpayer in the source country to verify the tax burden in the residence country in order to deduct an interest expense is impractical and an unacceptable burden to be carried by the taxpayer. The reporters propose that the tax authorities should find a solution so that the taxpayer will not be required to verify the tax burden of the non-resident. The implementation of such an anti-avoidance rule would also hamper Brazil in effectively implementing its tax policy in attracting foreign investments via tax incentives, e.g. the deductibility in the source country could be denied where the residence country exempts the corresponding income. In practice, the tax benefit (exemption) provided by the residence country (Brazil) would be offset by the source country.¹⁵⁴

For Colombia, the reporter questions the logic in implementing a domestic solution before the mechanisms of exchanging tax information between Colombia and other countries are in force.¹⁵⁵ Moreover, taxpayers should be given the opportunity to demonstrate a legitimate business purpose to enter a hybrid mismatch scheme to escape the application of the provisions aimed at preventing exemption or non-recognition for payments that are deductible by the payer. The reporter adds that such provisions should only be applicable to related parties, otherwise the taxpayer will have an unreasonable burden to demonstrate the tax treatment of income received by a third party with no obligation or interest to disclose such facts.

The reporter of Uruguay considered this issue is irrelevant to Uruguay, since this country has the territorial system of taxation. Neither foreign income nor losses are taken into account for purposes of Uruguayan tax law.¹⁵⁶ Seeing this issue more generally, i.e. from the perspective of other countries potentially involved in hybrid schemes, a deduction in a foreign country with non-inclusion in Uruguay may easily occur. A need to introduce a domestic anti-hybrid rule in Uruguay may still exist in light of the purpose of BEPS Action 2.

No restrictions were noted under the South African legal system that could prohibit this country to implement provisions preventing exemption or non-recognition for payments that are deductible by the payer.¹⁵⁷ Some provisions are already in force in South African domestic law whereby the participation exemption for foreign dividends does not apply where the dividend has been claimed as a tax deduction by a payer in the foreign country.¹⁵⁸

and the EC Treaty Freedoms A Study of the Limitations under European Law to the Prevention of Tax Avoidance, Eucotax Series on European Taxation, Vol. 11, the Hague: Kluwer Law International (2005), p. 158.

¹⁵⁴ See Brazil report at 15. Note that there is a parallel between this discussion and the issues around the tax sparing provisions applied by Brazil. In this scenario, it was suggested that the mismatches must be qualified, in order to verify whether the very avoidance of the mismatch is a goal to be pursued.

¹⁵⁵ See Colombia report at 16.

¹⁵⁶ See Uruguay report at 14.

¹⁵⁷ See South Africa report at 30.

¹⁵⁸ See section 10B(2) of the ITA (1962).

3.6.1.3 Introduction of domestic law provisions aimed at denying a deduction for a payment that is also deductible in another jurisdiction

Among all surveyed countries, only the South African reporters stated that there appears to be no bar to the introduction of such domestic law provisions aimed at denying a deduction for a payment that is also deductible in another jurisdiction.¹⁵⁹

However, no reporters considered such domestic intervention as a possibility, indicating that such intervention was not required. In the case of Brazil and Colombia, no provisions exist to consider foreign entities as tax transparent entities.¹⁶⁰ This means that the double deduction (i.e. a deduction in Brazil or Colombia and in a foreign country) issue does not arise from the perspectives of the Brazilian and Colombian jurisdictions whenever a foreign subsidiary of a Brazilian or Colombian parent pays tax deductible expenses. The same conclusion, albeit for a different reason applies to Uruguay. As tax deductible expenses paid by a foreign subsidiary of the Uruguayan parent will be disregarded for Uruguayan tax purposes as a result of the territorial tax system, domestic intervention to prevent double deduction is unnecessary.¹⁶¹ The Colombian reporter reiterated the need for sufficient exchange of tax information's mechanisms as a safeguarding provision (see section 3.6.1.2 above).

3.6.2 The assessment of anti-hybrid legal measures adopted by some OECD Countries

3.6.2.1 Rules requesting an attestation that the same expense or loss has not been deducted in another jurisdiction

Among all surveyed countries, only the South African reporters indicated that the such attestation rules could be introduced in the domestic tax law of South Africa.¹⁶² An attestation of foreign tax treatment in the context of foreign tax credits is already required. There would be no bar, in South Africa, to introducing similar attestation requirements for deductions.¹⁶³

For Brazil, Colombia, and Uruguay, the introduction of rules are impractical and irrelevant for the reasons supplied in section 3.6.1.3. above.¹⁶⁴

The Colombian reporter reiterated that rules requesting an attestation that the same expense or loss has not been deducted in another jurisdiction constitutes too great a burden on the taxpayer and thus should only be imposed for transactions between related parties. The Colombian reporter also underlined that even in such

¹⁵⁹ See South Africa report at 30. Note that on 12 May 2016, the SARS hosted an industry workshop to share initial views on hybrid debt rules avoidance schemes which they perceive to be of concern and the proposed measures that will be taken, see the summary online at:

[http://www.ey.com/Publication/vwLUAssets/South_African_Treasury_revisits_hybrid_debt_rules_to_prevent_double_non_taxation/\\$FILE/2016G_01001-](http://www.ey.com/Publication/vwLUAssets/South_African_Treasury_revisits_hybrid_debt_rules_to_prevent_double_non_taxation/$FILE/2016G_01001-)

[161Gbl_ZA%20reasury%20revisits%20hybrid%20debt%20rules%20to%20prevent%20double%20non%20taxation.pdf](http://www.ey.com/Publication/vwLUAssets/South_African_Treasury_revisits_hybrid_debt_rules_to_prevent_double_non_taxation/$FILE/2016G_01001-161Gbl_ZA%20reasury%20revisits%20hybrid%20debt%20rules%20to%20prevent%20double%20non%20taxation.pdf). The proposals under BEPS Action 2, however, remain under consideration but are not part of the current legislative cycle agenda in the South Africa.

¹⁶⁰ See Brazil report at 15 and Colombia report at 16 and 8. Cf. *supra* 3.1.1.1, 3.1.1.2, and 3.1.2.

¹⁶¹ See Uruguay report at 14. Cf. *supra* 3.1.1.1, 3.1.1.2, and 3.1.2.

¹⁶² See South Africa report at 31.

¹⁶³ See section 6(1A) of the ITA.

¹⁶⁴ See Brazil report at 15, Colombia report at 16, and Uruguay report at 14.

a narrow scope the attestation should only be requested in the jurisdiction of the parent or head office. It should not be requested in the jurisdiction of the subsidiary/permanent establishment, as the information flows between related parties are not symmetric. The parent company/head office could have legitimate reasons for withholding information from some of its subsidiaries/permanent establishments. Consequently, it should provide the information if the reason is legitimate. Lastly, the reporter indicated that a safeguard provision is essential to ensure the taxpayer's rights to prove the legitimate use of tax incentives. This is particularly important in the case of applying the rules in question in developing countries, because their tax policies are often concentrated on attracting foreign investments via tax incentives.

3.6.2.2 The introduction of disclosure initiatives targeted at certain hybrid mismatch arrangements

The issue of the introduction of disclosure initiatives targeted at certain hybrid mismatch arrangements is closely related to the considerations in section 3.6.2.1. above, since the obligation to disclose hybrid mismatch arrangement schemes coincides with the obligation to provide an attestation that the same expense or loss has not been deducted in another jurisdiction. In either case, taxpayers are obliged to submit information to tax authorities which is relevant for identifying and preventing tax arbitrage via hybrid mismatches.

Perhaps unsurprising, the pattern of answers is unchanged. Among all surveyed countries, only the South African reporter confirmed the possibility of the introduction of the rules in question, i.e. rules on disclosure initiatives targeted at certain hybrid mismatch arrangements. It follows from the fact that this country already has in force a reportable arrangement provision¹⁶⁵ and this mechanism could be extended to include targeted hybrid mismatch arrangements.¹⁶⁶

By contrast, the reporters of the other three countries were doubtful as to the introduction of such rules under their domestic legal systems.

Colombia only accepts official apostilled translations of foreign legislation. Disclosing initiatives targeted at certain hybrid mismatch arrangements will often involve legislations in different languages.¹⁶⁷ This creates a significant burden for taxpayers required to disclose their hybrid mismatch arrangements.

In the case of Brazil and Uruguay, there is a high risk that such disclosure rules will be unconstitutional or against their domestic law.¹⁶⁸

The reporter of Uruguay indicated that, in terms of Uruguayan law, some types of disclosure of information might be illegal, or against the constitution, which must be studied on a case by case basis.

¹⁶⁵ See section 35 of the Tax Administration Act.

¹⁶⁶ See South Africa report at 30. It should be noted that selected arrangements involving hybrid equity instruments are already reportable (see <http://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-TAdm-PN-2016-02%20-%20Notice%20140%20GG%2039650%203%20February%202016.pdf>).

¹⁶⁷ See Colombia report at 17.

¹⁶⁸ See Brazil report at 15 and Uruguay report at 14.

The reporters of Brazil explained that the mandatory disclosure may not be allowed under the Brazilian constitutional system in light of the constitutional guarantee that no one shall be required to produce evidence against themselves. Hence, the only acceptable solution in Brazil may be voluntary disclosure, as opposed to mandatory disclosure. The Brazilian reporters added that the application of mandatory disclosure to accountable individuals should not include advisors, counsellors and other third parties as it raises concerns in respect of professional secrecy or legal privilege.¹⁶⁹

3.6.2.3 Rules addressing abusive foreign tax credit transactions

Abusive foreign tax credit transactions do not seem to constitute a significant concern for the four countries surveyed. For Uruguay, such rules would be of no application since foreign tax credit are not be granted due to the use of a territorial tax system in this country. From a Brazilian tax policy perspective, abusive foreign tax credit transactions are not significant and therefore implementing the such rules is not in the interest of Brazil. In the case of South Africa, to the extent abusive foreign tax credit transactions fall outside the scope of the South African GAAR, such abusive foreign tax credit transactions could be combated by newly implemented anti-abuse provisions aimed specifically against the abusive foreign tax credit transaction. The Colombian reporter did not comment on the usefulness of such rules for Colombia, and just stated that such rules could be implemented in that country and they must always contain a safeguard provision allowing taxpayers to defend their transactions based on legitimate reasons.

3.6.3 The feasibility of introducing a “mutual recognition” principle

The principle of “mutual recognition” is based on the qualification established under the laws of the state of incorporation of a hybrid entity or the state of issuance of a financial instrument. It originates from the principle applied within the European Union in the context of trade in which a Member State should recognise the standards applied in the home state and, subject to the rule of reason principle, prohibit denial of access to its markets if these standards differ from its own standards.¹⁷⁰

For this paper, the OECD’s understanding of the “mutual recognition” principle in the context of dealing with outcomes of hybrid mismatches (the OECD’s linking rule) is followed. This principle should be understood as a system by which: (i) as regards a financial instrument, the state of holding of the financial instrument will follow the qualification given by the state of issue of this instrument, and (ii), as regards an entity, the counterparty state will follow the qualification given to an entity by the state of incorporation of the entity.¹⁷¹ This could have impact at two levels, i.e. transactions with the entity and profit distributions to members/disposals of member interests.¹⁷² The introduction of this principle is also understood to be an

¹⁶⁹ See Federal Constitution: Art. 5, X; Article 198, Law 5,172/1966 (National Tax Code); Supplementary Law 105/2001(for banking secrecy specifically); Article 116, Law 8,212/1990; Article 998 of Decree 3,000/1996 (Income Tax Code); Ordinance RFB 2,344/2011 and Ordinance RFB 3,541/2011. Other legislation and regulations at the State and Municipal level regarding the professional secrecy may apply.

See Brazil report at and Brazil report on OECD Action Plan on Base Erosion and Profit Shifting (BEPS), at 16.

¹⁷⁰ See Ph. Genschel, *Why no mutual recognition of VAT? Regulation, taxation and the integration of the EU’s internal market for goods*, 14 *Journal of European Public Policy* 5 (2007), p. 748.

¹⁷¹ See (OECD 2015), *supra* n. 12, pp. 11-12.

¹⁷² Cf. Article 9 of a Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, Official Journal of the European Union of 17 July 2016. This Directive says that “To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment

alternative solution to a process of amending the domestic laws of the various countries to achieve coordination between different domestic laws.¹⁷³

The reporters of surveyed countries took differing views on the feasibility of introducing such a “mutual recognition” principle based on the qualification established under the laws of the state of incorporation of a hybrid entity or state of issuance of financial instrument.

The introduction of such a mutual recognition principle was most positively accepted by the reporters of Brazil. They agreed that the qualification respectively in the state of incorporation for hybrid entities and the state of issuance for hybrid instruments are adequate parameters for applying the mutual recognition principle.¹⁷⁴ This positive view from the Brazilian reporters may stem from Brazil’s similar approach in relation to conflict of qualifications under the interest article in Brazilian tax treaties.¹⁷⁵

The reporter of Uruguay said that it is unlikely that such a “mutual recognition” would be implemented with the support of Mercosur (Spanish: Mercado Común del Sur). The regulations of Mercosur do not contain provisions harmonizing the tax systems of its member countries.¹⁷⁶ However, the introduction of the “mutual recognition” principle may remain possible in Uruguay when compared to the Uruguayan domestic tax rule “regla candado”, i.e. the rule of application which concerns the tax treatment of payments made by a Uruguay tax resident to a foreign tax resident.

The Colombian reporter pointed out that while the mutual recognition principle may be effective for countering tax arbitrage via hybrid mismatches, its application carries a danger of loss of tax revenue for developing countries, such as for Colombia. Such a mutual recognition principle currently favours the developed world (as capital exporters).¹⁷⁷ Under such a principle, developing countries, including Colombia, may be forced to give up their domestic (sovereign) definition of residence or of interest in order to apply the definition of a foreign (developed) jurisdiction.¹⁷⁸ The reporter also indicated that the state of incorporation or issuance is easily interchangeable, and therefore taxpayers may incorporate companies or issue instruments in the jurisdictions with the most favourable definitions from the taxpayers’ perspective. Such jurisdictions will most often be countries in the developed world, for instance Delaware or Nevada states, for the American region, or certain EU Member States, for example Cyprus, Ireland or Luxembourg. Hence, the Colombian reporter concluded, the mutual recognition principle could be acceptable for Colombia and other developing countries, but only if the developing countries were involved in the discussion on the criteria for classifying an entity or instrument under the mutual recognition principle, and if manipulation of these conditions by taxpayers would not be easy.

has its source. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.” Thus, under this Directive, the qualification of the financial instrument/hybrid entity of the state in which the payment has its source should be followed by the other state (the state of recipient of that payment).

¹⁷³ Cf. V. Thuronyi, *Coordination Rules as a Solution to Tax Arbitrage*, Tax Notes International (2010), pp. 1053-1060 and *supra* section 2.

¹⁷⁴ See Brazil report at 16. Even though there was some debate on whether the state of incorporation is a better parameter than the state of source, the reporters tended to regard the former as the best approach, to ensure a uniform treatment on transactions with different jurisdictions. Regarding hybrid instruments, the state of issuance was not questioned as the best approach.

¹⁷⁵ See *supra* 3.4.1.3.

¹⁷⁶ See Uruguay report at 15.

¹⁷⁷ See Colombia report at 17.

¹⁷⁸ Although this will also work the other way around, it is likely that it will not be symmetric in practice, i.e. it will favour developed countries’ fiscal interests at the expense of developing countries.

The South African reporter analysed potential effects of the implementation of the mutual recognition principle in South Africa in various iterations, i.e. in relation to the tax treatment of hybrid instruments and hybrid entities (partnerships, trusts, and tax consolidated groups). The reporter concluded that from a revenue collection perspective, the implementation would appear to have little impact when changing the qualification of the entity, but may have significant impact when changing the qualification of a hybrid instrument.¹⁷⁹ Similar to the conclusions from Colombia, the reporter indicated that South Africa, as a net importer of capital, would generally be expected to be the accommodator of foreign qualifications. This would mean that local tax revenues would be enhanced or compromised depending on whether the revised qualification of a hybrid instrument (i.e. after an application of the mutual recognition principle by South African tax authorities) would lead to the granting or denial of deduction that would otherwise have been denied or allowed. South Africa's domestic law does include anti-tax avoidance provisions which operate to deny deductions in respect of certain specified hybrid instruments and transfers. Accordingly, a mutual recognition policy would only enhance revenue collection in those instances not covered by the anti-tax avoidance currently in force in South Africa. Generally, it may be difficult to conclude definitively on the likely impact on local revenue collection as the use of hybrid financing is unlikely to be equally distributed between those countries that provide funding to South Africa. The reporter concluded, however, that an application of the mutual recognition principle may introduce a bias towards reduced revenue collection in South Africa and it is in any event likely to introduce uncertainty in respect of local revenue collection.

Furthermore, the South African reporter, similarly to the reporter of Colombia, indicated that the implementation of the mutual recognition principle can trigger qualifications to the benefit of revenue collection in developed countries. Since the South African government sees itself as having a development responsibility, it may be unwilling to introduce policies stemming from the mutual recognition principle which prejudice revenue collection in South Africa. However, South Africa has committed itself to supporting the international fiscal community in its BEPS measures, including Action 2,¹⁸⁰ and thus it seems that the solution may be to partly implement the mutual recognition principle, for instance only in respect of entity qualifications.

Lastly, the reporter of South Africa stated that South Africa is perceived by other member states of the Southern African Development Community (SADC) as the dominant supplier of capital between members. It is thus questionable whether member states of the SADC would agree to the policy promoted under the mutual recognition principle if it would result in giving up tax revenue in favour of South Africa.

3.6.4 The possibility of the creation of a forum for sharing expertise, best practices, and experience in tax administration to combat abusive tax schemes

Tax arbitrage by means of hybrid mismatches feeds on the informational asymmetry of the tax administrations of the concerned countries, with regard to the respective tax treatments of certain entities and financial instruments. In this respect, administrative co-operation on exchanging of tax information would

¹⁷⁹ See South Africa report at 31-36.

¹⁸⁰ See (OECD 2015), *supra* n. 12.

provide a necessary tool for an introduction and application of domestic and treaty rules aimed against situations that may have allowed tax arbitrage via hybrid mismatches. It is however not so straightforward to pick an information exchange strategy suitable for the task. In this respect, an arrangement possibly worthy of considering is the Joint International Tax Shelter Information Centre (J.I.T.S.I.C.), set up by the tax administrations of Australia, Canada, the United Kingdom and the United States (later joined by Japan) in 2004.¹⁸¹ The most noticeable feature of J.I.T.S.I.C. is the maintenance of a discussion forum to share expertise, best practices and experience in tax administration to combat abusive tax schemes. In this regard, the questions to be answered by the surveyed countries are: (i) whether the creation of such a forum, possibly at a regional level, would be realistic and sustainable based on the capacity of the tax administration of a surveyed country and (ii) how would that country amend the current structure of such forum (if at all) in order to better suit the needs and potential of the country's tax administration?

South Africa has already confirmed a willingness to participate in such fora via its partnership in the OECD's Convention on Mutual Administrative Assistance in Tax Matters. Furthermore its partnership in a tax co-operation agreement with India and Brazil could allow for co-operation as envisaged above. The South African Revenue Service (SARS) appears to have the resources to participate in such a forum in a meaningful way and therefore South Africa should be able to accommodate this project through its current structures.¹⁸² South Africa therefore appears prepared, legally and structurally speaking, to create and maintain a discussion forum to share expertise, best practices and experience in tax administration to combat tax avoidance.

The Colombian reporter emphasized that forums, such as the JITSIC, provide a means for tax administrations to obtain information without placing an unnecessary burden on the taxpayer.¹⁸³ The reporter stated that such forum could be established in Colombia and other Latin American countries. For efficient and effective sharing of information it is recommended that delegates of such forum should be only those from the highest level of the tax administrations of the Latin American countries. This would ensure that the forum will understand the gathered information and provide valuable insights that are not yet common amongst lower level tax officials of Latin American countries. Importantly, the reporter expressed concern related to the potential cost of setting up and maintaining a working forum among Latin American countries, since the tax administrations of these countries are struggling with low budgets and almost non-existent budgets for travel expenses. Hence, the reporter underlined that this financial challenge must be addressed before implementing a forum of this nature among Latin American countries. A proposed solution would be to utilise existing networks and structures, such as creating a sub-commission at the Inter-American Center of Tax Administrations ("CIAT"), to host such a forum.

The reporter of Uruguay was not as supportive as the reporter of Colombia with respect to the establishment of such fora. The reporter believes that although the Uruguayan tax authorities are improving their

¹⁸¹ Introductory background information on J.I.T.S.I.C. can be found online at: <http://www.hmrc.gov.uk/avoidance/aag-jitsic.htm>

¹⁸² See South Africa report at 37.

¹⁸³ See Colombia report at 18. The reported indicated that the members of JITSIC are transparent about their findings, publishing domestic rulings and lists of tax shelter or abusive transactions so that the taxpayer may have legal certainty. Furthermore, most of the countries involved in JITSIC have a similar legal background and share the same language. This would strengthen the case for creating a regional forum with countries sharing a language and a similar legal and tax structure.

relationships with foreign tax authorities through signing several TIEAs in the past few years, they have not reached a position yet in which an administrative co-operative forum could be established which would function at the level described above.¹⁸⁴

In the case of Brazil, the reporters believe that the CIAT could potentially play the role of the mentioned forum. Due to the lack of information regarding the functioning of the CIAT, it is currently not possible to determine the feasibility of the implementation and enforcement of that option.¹⁸⁵ The reporters also cautioned that in establishing a forum involving countries exchanging tax information, the taxpayer's rights to protect their personal data should be respected, i.e. the exchange of tax information among the tax administrations of involved countries should be done with proper notifications of taxpayers about the type of exchanged information and the taxpayers should be in position to express their opinion on the information exchanged. The issue, however does not arise insofar as such exchange does not reveal the identity of the taxpayer.

4 Conclusions and Recommendations

The comparative analysis of the issues related to tax arbitrage via hybrid mismatches in Uruguay, Colombia, Brazil and South Africa allows us to make several conclusions. These will be followed by tax policy recommendations enabling developing countries to deal with this issue. The conclusions are predominantly drawn from the analysis in section 3, while the recommendations are drawn from a synthesis of all conclusions as well as from the analysis and observations of the reporters of the surveyed countries with respect to the topics noted in section 3.

As the overview in section 3.6. shows, reaction to tax arbitrage via hybrid mismatches appears advanced in the South African tax administration. While tax administrations in Colombia, Brazil and Uruguay appear to have not shown very much interest in this regard so far, this level of reaction seems to be changing. In part, the reaction and lack of reaction seems to lie with willingness and readiness to deal with hybrid mismatches. Interestingly, South Africa's awareness of tax arbitrage via hybrid mismatch arrangements does not translate to co-operation between tax practitioners and tax administration in that country.¹⁸⁶ It appears that tax authorities in Colombia, Brazil, and Uganda see few or no arrangements involving tax arbitrage via hybrid mismatches, even though they exist among tax practitioners in these countries.

The analysis of case studies by the surveyed countries with respect to tax arbitrage via hybrid mismatches reveals that schemes resulting in double deduction do not generally occur from the view of the surveyed countries if they are the country of residence of a parent company providing a loan to a foreign subsidiary.¹⁸⁷ This is explained in that Brazil, Colombia, and South Africa have no tax provisions allowing their tax authorities to identify a foreign subsidiary as a tax transparent entity. Furthermore, Uruguay's territorial tax system does not address foreign income/losses for domestic tax law purposes. Conversely, hybrid mismatch

¹⁸⁴ See Uruguay report at 15-16.

¹⁸⁵ See Brazil report at 16.

¹⁸⁶ This is perhaps explained in tax advisors being unwilling to share their knowledge of hybrid mismatch schemes with the tax authorities as they want to protect their clients from potential loss of tax benefits and tax authorities not wanting to reveal potential audits or test cases.

¹⁸⁷ Apart from the assumptions related to South Africa in Scenario A in section 3.3.1.2. according to which the hybrid entity situated in Country B is a trust and income or capital net of trust expenses is vested in a holding company resident in South Africa.

schemes seem to achieve double deductions where the subsidiary company paying interest to its parent company has its residence in the surveyed country. The same trend is observed with respect to hybrid schemes resulting in deductions with non-inclusion. While these findings may appear obvious as a result of multinational companies establishing subsidiaries in developing countries, there is an increasing trend of multinational companies in developing countries establishing subsidiaries in other countries, for example the Brazilian and South African multinational companies.¹⁸⁸ Thus, the findings are relevant for tax policy recommendations for such jurisdictions.

Adding to the difficulty in application and awareness in the surveyed countries is the lack of case law in all. Only Colombia had publicly considered transactions utilizing hybrid mismatches. No data appears to be collected (at least no data exists in the public domain) measuring the revenue impact of tax arbitrage via hybrid mismatches in each of these countries. This is perhaps unexpected as it is usually impossible to conduct these measurements accurately or even based on the same assumptions in each jurisdiction. Difficulties in measuring frequently arise as, often with mismatches, from the perspective of one of the countries the hybrid mismatches does not result in minimization of taxation, nor in many cases is the mismatch contrary to the wording, or even the spirit, of the tax laws of the two (or more) countries. Mismatches do, however, take advantage of disparities and inconsistencies between tax laws of investigated countries (at least two). It is therefore usually impossible to determine which of two countries has lost its tax revenue, since both countries collect the exact amount of tax stipulated by their tax laws.¹⁸⁹

The analysis of current and prospective domestic and tax treaty provisions and practices aimed at preventing tax arbitrage via hybrid mismatches in the surveyed countries shows that South Africa is the only country to have legislated explicitly against tax arbitrage via hybrid mismatches, albeit not necessarily reflecting recommendations under BEPS Action 2. Nevertheless, South Africa appears to be the most inclined and prepared to follow the recommendations of the OECD under BEPS Action 2 of all surveyed countries. Although the legislation that is in force in Uruguay is not specifically aimed at hybrid mismatch arrangements, the linkage rule “regla candado” – restricting the deductibility of interest paid by a Uruguayan company to a foreign lender if the lender is not taxed on the interest received from Uruguay – may have a direct impact on hybrid mismatch arrangements. Its existence, though, stems rather from Uruguay’s territorial tax system (i.e. excluding foreign income and expenses from being taken into account for purposes of taxation of residents) than its anti-hybrid tax policy. In Colombia and Brazil, only parts of their legislation are likely to affect hybrid mismatch arrangements, and then only indirectly. From the evidence collected it would seem that the above positions of the surveyed countries arise from: (i) awareness and willingness to deal with tax arbitrage via hybrid mismatches; and (ii) the development of internal and external legal mechanisms aimed at tackling hybrid mismatches – a process that is also more advanced in South Africa compared to other countries in this study.

¹⁸⁸ As pointed out by the reporters of Brazil and South Africa at the Conference “A Sustainable Path for Tax Transparency in Developing Countries”, 27 June, 2016, Oslo, see online: <http://www.jus.uio.no/ior/english/research/projects/global-tax-transparency/events/conferences/a-sustainable-path-for-tax-transparency-in-develop.html>.

¹⁸⁹ See Lüdicke, *supra* n. 118, p. 51. Cf. (OECD 2015), *supra* n. 12, paragraph 2 at p. 15. Although the overall effect of the tax arbitrage via hybrid mismatches could perhaps be measured, this has never been done by the surveyed countries.

Nonetheless, in all the surveyed countries there appear to be no administrative guidelines discussing the scope and effects of tax arbitrage via hybrid mismatches or clarifying how anti-hybrid rules should be applied. This is not a unique position and can be juxtaposed with the German experience – German tax authorities have not issued any guidelines on the application of the German anti-hybrid rules for a decade, even though these rules were considered to be notably opaque from the start and have never been applied by tax authorities.¹⁹⁰ This, however, did not prevent the OECD from promoting the German rules in the 2012 Report on Hybrid Mismatch Arrangements.¹⁹¹ Of course, it is not certain whether the problems in Germany are inherent in rules of this nature; they may indeed occur in other countries, including the surveyed developing countries, or if they may be caused by peculiarities of the German tax system. What is certain, however, is that the hybrid mismatches emerged years ago in Germany and remain despite the country's highly developed tax administration and internationally competitive economy. From this evidence, two conclusions can be drawn. First, *a fortiori*, if a large, highly developed country like Germany, with long-standing experience of combating tax avoidance and a well-functioning tax administration with the tools necessary to exchange tax information and knowledge of international tax law, has not been able, for more than ten years, to design and implement effective and appropriate anti-hybrid rules, it is unlikely that developing countries, including the surveyed countries, will be in a position to legislate and enforce domestic anti-hybrid rules in short order. Second, the OECD is noticeably one-sided when it comes to dealing with hybrid mismatches in the sense of focusing essentially on preventing double non-taxation or double deductions, without considering the problems that are likely to arise from the application of anti-hybrid rules.

Turning to the recommendations for the surveyed countries regarding the feasibility of introducing the outcomes of the BEPS Action Plan 2, our general impression is that the surveyed countries, with the possible exception of South Africa, are currently not well prepared to do so. For this reason implementation of the BEPS Action Plan 2 cannot be recommended as a policy option for these countries at present. The recommendations under BEPS Action 2 should be carefully evaluated by these countries for implementation at a future date. However, an approach for the surveyed countries to adopt is provided in the form of three recommendations, which may be implemented consecutively or in parallel, depending on the needs. The surveyed countries should evaluate how to take the recommendations listed below into account (or at all) and whether or not to prioritize them in the order proposed below. The recommendations are more interconnected to each other than mutually exclusive.

Recommendation I – Create effective legal mechanisms enabling the exchange of tax information

The surveyed countries should introduce and/or further develop legal and administrative mechanisms that enable them to identify tax arbitrage by means of hybrid mismatches. A necessary ingredient here is effective legal arrangements allowing for the exchange of tax information. Without such mechanisms in place, anti-hybrid rules will be invalidated, since tax authorities will be unable to obtain and verify the information necessary for applying such rules. The OECD's linking rule, based on the mutual recognition principle, requires an effective exchange of information. The principle can only apply if the tax provisions of the payee's country are known and understood by the payer's country (primary rule), and vice versa (defensive

¹⁹⁰ See Lüdicke, *supra* n. 118, pp. 54-56.

¹⁹¹ See OECD (2012), *supra* n. 23, paragraph 39 at p. 15.

rule).¹⁹² This highlights the need for a strong system of tax information exchange rules¹⁹³ complementing the anti-hybrid rules. The most important step toward the prevention of tax arbitrage via hybrid mismatches in the surveyed countries is to meet the standard of global fiscal transparency, since this standard assumes a well-functioning system of information exchange.

Recommendation II – Increase human capacity, and technical and substantive knowledge required for identifying and dealing with tax arbitrage via hybrid mismatches and develop a cooperative relationship between tax administrations and taxpayers

The surveyed countries should increase the human capacity and technical and substantive knowledge of employees of the tax administrations to gain the expertise to address cross-border tax avoidance, including tax arbitrage via hybrid mismatches. Only after gathering, systematizing and understanding this knowledge will the surveyed countries be positioned to effectively proceed with further legislative action, such as the recommendations under BEPS Action 2. Furthermore, there is no reason to adopt the BEPS Action 2 recommendations if the peculiarities of domestic legislation make the perceived BEPS risk unlikely.

The surveyed countries could consider facilitating the cooperation between taxpayers and their tax advisors and the tax authorities in relation to tax arbitrage via hybrid mismatches. This would not only accelerate the process of identifying hybrid mismatches schemes by the tax administration, but also give tax advisors and their clients a voice in the prospective design of legal solutions in response to abusive hybrid arrangements. All concerned parties could benefit from this approach: tax authorities will increase their awareness of tax arbitrage via hybrid mismatches, while tax advisors and taxpayers will be duly informed about the legislative and administrative boundaries in the use of hybrid entities and instruments.

Recommendation III – design appropriate legal solutions for dealing with tax arbitrage via hybrid mismatches

It would seem to follow that after the surveyed countries gain sufficient capacity and knowledge about tax arbitrage via hybrid mismatches and the dialogue between tax administrations and taxpayers on this issue is underway, the countries will be better positioned to consider appropriate legislative solutions to hybrid mismatches. It is recommended that Brazil, Colombia, South Africa, and Uruguay take into account peculiarities of their legal systems and the prosperity of their economies in the consideration of any implementation of the OECDs recommendations under BEPS Action 2. Several observations from the evidence analysed in section 3 should specifically be considered.

First, there would appear to be no reason to implement anti-hybrid rules aimed at preventing double deductions or deductions with non-inclusions by the surveyed countries in cases where the parent company providing a loan to a foreign subsidiary is resident in one of the surveyed countries. As demonstrated above, in these cases neither double deductions nor deductions with non-inclusions appear as a result of the current structure of the tax systems of the analyzed countries. However, anti-hybrid rules may be needed to target schemes where the parent company is resident outside these countries.

¹⁹² Cf. Rust, *supra* n. 29, p. 324.

¹⁹³ Cf. Ph. Baker, *Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion*, in *Papers on Selected Topics in Administration of Tax Treaties for Developing Countries*, Paper No. 9-A, UN, May 2013, available online at: http://www.un.org/esa/ffd/wp-content/uploads/2013/05/20130530_Paper9A_Baker.pdf, p. 4; F. Zimmer, *Skatteparadis – noen skatterettslige problemstillinger*, 50 *Lov og Rett* 4 (2011), p. 239; M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, 32 *Intertax* 2 (2004), p. 111.

Second, even where anti-hybrid rules could be of relevance to the surveyed countries, the countries should analyse the impact these rules may have on the growth of their economies versus any additional taxes collected. Anti-hybrid rules should not be implemented if their application, as proposed under BEPS Action 2, is likely to have a negative impact on economic growth and/or tax collection. A good example (described in section 3.6.3. above) is the mutual recognition principle which is considered to prejudice revenue collection in South Africa and Colombia. It is anticipated that these countries would be most unwilling to implement this principle.

Thirdly, where these countries have or may wish to create tax incentives under their domestic tax laws in line with the countries' policies to attract foreign investment, it may be found that implementation of anti-hybrid rules may damage such incentives. This concern was repeatedly emphasized by the reporters of Colombia and Brazil.¹⁹⁴ The surveyed countries should at least evaluate whether the recommendations under BEPS Action 2 will distort their current tax policy on granting tax incentives.

Finally, to the extent that an introduction of anti-hybrid rules will be justified in the surveyed countries, they should bear in mind the following issues while doing so.

- (i) BEPS Action 2 envisages a complex and comprehensive package of legal solutions. This may contradict administrative simplification, which is one of the main concerns when drafting tax rules for developing countries. Law makers and tax administration officials in developing countries often lack the necessary technical and legal expertise to design and apply complex and comprehensive anti-tax avoidance provisions.¹⁹⁵ The lack of administrative simplification may also hinder transparency in the application of tax law and judicial review of administrative decisions, indirectly increasing the possibility for corruption in developing countries.¹⁹⁶
- (ii) The application of the primary linking rule obliges the payer's jurisdiction, rather than the payee's, to tax that part of the payment not included in the recipient's income. The defensive linking rule obliges the payee's jurisdiction to tax income derived from abroad without connection to the jurisdiction of the recipient. As a result of the application of defensive linking rules, the tax base of the source state can be eroded, and the right to levy tax falls back to the payee's country.¹⁹⁷ This reveals that the primary and defensive linking rules contribute to the achievement of the general approach of the OECD, which is that "all income should be taxed somewhere",¹⁹⁸ rather than to the achievement of the purpose according to which "all income [is] taxed where economic activities generating the income are performed and where value is created".¹⁹⁹ The division of tax revenue under the principle of "all income should be taxed somewhere" may not guarantee the coherence of the international tax system, as is the purported aim of the OECD.²⁰⁰

¹⁹⁴ See *supra* 3.6.1.1, 3.6.1.2 and 3.6.2.1 with respect to Brazil and Colombia.

¹⁹⁵ See T. Dubut, *Designing Anti-Base-Erosion Rules for Developing Countries* in G. M. M. Michielse and V. Thuronyi, *Tax Design Issues Worldwide*, Alphen aan den Rijn: Wolters Kluwer Law & Business, 2015, p. 154

¹⁹⁶ *Id.*

¹⁹⁷ See Ch. Kahlenberg and A. Kopec, *Hybrid Mismatch Arrangements – A Myth or a Problem That Still Exists?*, 8 *World Tax J.* 1 (2016), p. 74.

¹⁹⁸ See G. S. Cooper, *Some Thoughts on the OECD's Recommendations on Hybrid Mismatches*, 69 *Bull. Intl. Taxn.* 6/7 (2015), p. 345.

¹⁹⁹ See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements*, (OECD, 2014), p. 3, International Organizations' Documentation IBFD.

²⁰⁰ See Kahlenberg and Kopec, *supra* n. 197, p. 75.

- (iii) It appears that the implementation of the recommendations under BEPS Action 2 may create legislative problems in the surveyed countries, not in the least because the complexity.²⁰¹ Furthermore, BEPS Action 2 does not provide the “legal language” for the recommended rules. Legislators of interested countries must themselves find reasonable wording for the anti-hybrid rules that is compatible with their respective legal system.²⁰² This may prove difficult in many developing countries (including those surveyed). Furthermore, introducing mandatory disclosure requirements targeted at certain hybrid mismatch arrangements would most likely be unconstitutional in Brazil and Uruguay. Even if successfully introduced, such disclosure would place an unreasonably high burden of proof on taxpayers.²⁰³ It is proposed that the only acceptable solution for the disclosure in terms of the application of anti-hybrid rules in the surveyed countries would be voluntary disclosure.
- (iv) Finally, BEPS Action 2 explicitly implies an automatic application of the proposed anti-hybrid rules if a hybrid mismatch arrangement “gives rise to a mismatch in tax outcomes that can be attributed to the hybrid element in the arrangement.”²⁰⁴ This may in many instances entail the application of anti-hybrid rules beyond tax avoidance cases, thus entirely missing the target of tax arbitrage via hybrid mismatches.²⁰⁵ It contradicts the text of paragraph 4 of BEPS Action 2 saying that “the recommendations for the design of the domestic law rules called for under Action 2 ... neutralise the mismatch in tax outcomes under a hybrid mismatch arrangement *without disturbing any of the other tax, commercial or regulatory consequences* (hybrid mismatch rules)” [emphasis added]. It would seem inappropriate to apply anti-hybrid rules automatically. At the very least, a safeguard provision should be introduced to allow taxpayers to demonstrate a legitimate business purpose for entering a hybrid mismatch scheme (before application of the anti-hybrid rule) and therefore avoid the application of anti-hybrid rules. It is submitted that these rules, if necessary at all in the surveyed countries, should only be applicable to tax avoidance cases.

²⁰¹ Cf. Lüdicke, *supra* n. 118, p. 52. It includes six different rules for six identified hybrid scenarios with 15 pages of summary for all twelve recommendations, 130 pages of detailed explanation and description and another 280 pages of examples “to explain the operation of the rules in further detail”.

²⁰² Cf. Lüdicke, *supra* n. 118, pp. 51-53.

²⁰³ See *supra* 3.6.4.

²⁰⁴ See OECD 2015, *supra* n. 12, paragraph 281 at p. 95.

²⁰⁵ See *supra* 1.