SCHOOL OF ACCOUNTANCY

Trusts in Hybrid Mismatch Arrangements: Does the OECD BEPS Action Plan adequately address the unique attributes of trusts?

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DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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ABSTRACT

This paper assesses whether the Organization for Economic Co-operation and Development (OECD) has effectively neutralised trust-based hybrid mismatch arrangements with the recommendations incorporated in Action 2 of the Base Erosion and Profit Shifting (BEPS) Action Plan. The OECD employed a consequentialist approach to hybrid mismatch arrangements, focusing on mending the outcomes of mismatch transactions as opposed to the source of the mismatches. Since trusts comprise several distinctive attributes, such as conflicts of attribution, which may result in mismatches, the OECD encountered difficulties in addressing trust-based mismatched systematically through the consequentialist approach. Slow convergence from the international community represents a further threat to the success of the OECD initiative. This paper will explore the adoption of the Action 2 recommendations concerning trust-based mismatches within the international community, placing a focus on South Africa. Possible alternatives to address hybrid mismatch arrangements will also be assessed.

Key words: Base Erosion and Profit Shifting, OECD, Action Plan, Action 2, Hybrid Mismatch Arrangement, Trust, Reverse Hybrid.

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ABBREVIATIONS

ATAF	African Tax Administration Forum
ATAP	Anti Tax Avoidance Package
ATAD 1	First Anti Tax Avoidance Directive
ATAD 2	Second Anti Tax Avoidance Directive
BEPS	Base Erosion Profit Shifting
CSR	Corporate social responsibility
DD	Dual deduction or double deduction
D/NI	Deduction/non-inclusion
DTA	Double tax agreement
EC	European Commission
ECJ	European Court of Justice
EU	European Union
GAAR	General anti-avoidance rule
IFA	International Fiscal Association
ITA	Income Tax Act
MNE	Multinational enterprise
OECD	Organization for Economic Co-operation and Development
POEM	Place of effective management
UK	United Kingdom
US	United States

CHAPTER 1: INTRODUCTION

Base erosion and profit shifting (BEPS) refers to the practice of reducing taxable income through the exploitation of gaps in the interaction between different tax systems. The concept of aggressive tax planning and the associated use of hybrid mismatch arrangements are key concerns in the BEPS discussion. In 2013 the Organisation for Economic Co-operation and Development (OECD) identified the need to curtail BEPS in a holistic and coordinated manner[1] in its initial report *Addressing Base Erosion and Profit Shifting*. In its 2014 *Action Plan on Base Erosion and Profit Shifting*, the OECD identified 15 action items spanning some highly complicated topics relevant to the BEPS initiative, including hybrid mismatch arrangements, transfer pricing, and the rise of the digital economy. Action 2 of the plan[2] was designated to neutralising hybrid mismatch arrangements resulting from differences in both entity and instrument classifications across jurisdictions. The OECD aimed to address hybrid mismatch arrangements through a system of 'linking rules' consisting of an offensive rule to be implemented in the source jurisdiction of a given transaction and a defensive rule to be implemented in the payee jurisdiction. A highly aggressive timeline of just 2 years was adopted for finalisation of the Action Plan.

Given the short timeline, the finalised *Action 2 Report*[3] appears impressive in its 450 pages; however, the highly detailed recommendations do not represent the holistic and coherent approach which the OECD sought to achieve. The recommendations concern 'the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements'[4] with the domestic recommendations incorporated in Part I and the treaty recommendations in Part II. They are highly detailed, comprising an intricate system – a far cry from the original promise of coherence. Recommendations 4 and 5 of Action 2 are most relevant to trust-based

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[1] OECD 2013a, *Addressing base erosion and profit shifting*, p. 50.
[2] OECD 2014d, *Neutralising the effects of hybrid mismatch arrangements, OECD/G20 base erosion and profit shifting project.*
[3] OECD 2015a, *Neutralising the effects of hybrid mismatch arrangements, Action 2 – 2015 final report, OECD/G20 base erosion and profit shifting project*.
[4] *Id.* at 11.

hybrid mismatch arrangements. Recommendation 4 contains general rules for cross-border payments to reverse hybrids and Recommendation 5 contains specific recommendations for the domestic tax treatment of reverse hybrids. Countries are now in the process of considering and implementing the OECD recommendations.

The BEPS initiative is exceptional in that it is driven not only by policymakers and bureaucrats, but by the international outcry which grew from the 2008 financial crisis. BEPS practices are enabled by the fact that cross-border tax policies have failed to keep up with the fast-changing environment of modern commerce and finance. While tax policy is considered a key aspect of state sovereignty, lack of harmonization between tax systems created opportunities for multinational enterprises (MNEs) to reduce their overall tax burdens significantly. Media networks generated unprecedented hype over exposing the tax practices of MNEs. Scholars[5] predicted the international unrest that would follow. The urgency of the project can certainly be attributed to the public pressure placed on governments.

The Action Plan represents a significant commitment of the OECD and G20 countries to work towards solutions for the identified problems. None the less, real and significant change is difficult to design and implement. The OECD has opted to patch up old anti-abuse rules instead of delivering the comprehensive change promised. This is particularly evident in the Action 2 recommendations: the linking rules constitute a complex system which force countries to rely on foreign legislation, often changing according to the type of hybrid entity or instrument employed, and at times bringing other anti-abuse rules (such as controlled foreign company (CFC) legislation) into the intricate system.

When applied to the more complex structure of the trust, the linking rules can create even more confusion. The recommendations do not account for the distinctive taxation features of the trust, such as grantor/settlor attribution and differential transparency.[6] The

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[5] Avi-Yonah, RS 2000b, 'Globalization, tax competition, and the fiscal crisis of the welfare state', *Harvard Law Review*, vol. 113, no. 7, pp. 1573-1676. Avi-Yonah argues that if tax evasion by rich individuals and tax avoidance by multinational enterprises (MNEs) continues to undermine the ability of developed and developing countries to provide adequate social insurance for their citizens, a violent reaction against globalization may end the current era of open borders, just as World War I curtailed globalization a century ago.

[6] Brabazon, M 2018, 'Beps Action 2: trusts as hybrid entities', *British Tax Reviw*, issue 2, pp. 211-242.

patchwork reliance on old anti-abuse rules becomes problematic. While the primary offensive rule is detailed in recommendation 4, a secondary defensive rule is absent. It appears that justification for its absence is the dependence on CFC or grantor/settlor attribution rules already in place in many jurisdictions. The result is that double taxation outcomes are even more likely when applying the rules to trusts because in all other applications of Action 2 the secondary rule is conditional on the non-application of the primary rule. Furthermore, instead of making a fresh start through ingenious change, the patchwork system ensures that implementation of the recommendations will be uneven amongst jurisdictions, leading to further opportunities for the use of hybrid mismatch arrangements. With this approach the OECD has failed to systematically address trust-based hybrid mismatch arrangements and has indeed created outcomes which have the potential to generate double taxation.

THE RESEARCH PROBLEM

Statement of the Problem

The research will assess whether the OECD recommendations contained in the BEPS Action 2 adequately consider the distinctive attributes of trusts in its attempt to neutralise hybrid mismatch arrangements. Trusts comprise a number of distinctive tax features, such as but not limited to rules of grantor attribution and differential transparency, which have the potential to generate both double taxation and double non-taxation. The structure of a trust makes it suitable to take the form of both a hybrid and reverse hybrid entity, with reverse hybrid mismatch arrangements being the most common outcome. Recommendations 4 and 5 of Action 2 pertain to payments involving reverse hybrid entities. The research will therefore focus on these recommendations to ascertain whether the OECD has successfully neutralised trust-based mismatch arrangements.

Sub-Problems

What are the aims of the OECD BEPS Action Plan?

To assess the success of the OECD Action Plan, it is necessary to understand the broader aims of the initiative, as well as the concepts which underpin it, such as the single tax principle and the benefits principle.

How does nontaxation of trusts occur?

Since the trust is distinctive in its tripartite structure, it is necessary to understand how this structure creates double non-taxation that may have created difficulties for the OECD to address in its recommendations. It is also necessary to understand which aspects of nontaxation resulting from trust-based structures the OECD has attempted to mend.

Do the recommendations achieve the OECD's aim to eliminate double non-taxation?

An assessment of the OECD Recommendations is required to understand whether tax neutrality (neither double taxation nor double non-taxation will occur) has been achieved.

How have the Action 2 recommendations in relation to trust-based mismatches been adopted both internationally and in South Africa?

One factor in assessing the success of the OECD is understanding how the recommendations have been enacted.

Are there alternative solutions?

After assessing the success of the OECD Recommendations and pinpointing weaknesses, it may be necessary to assess whether alternative suggestions present more viable solutions.

CHAPTER OUTLINE

Chapter 2 explores the development of the OECD BEPS Action Plan and the historical context and the political context in which initiative was conceived. The development of the international tax regime through bilateral tax treaties coupled with the failure of cross-border taxation rules to keep up with the realities of modern commerce led to a public outcry. Several key concepts upon which the BEPS Action Plan is based will be explained, including the single tax principle, the benefits principle, and aggressive tax planning.

The distinctive attributes of trusts that contribute to mismatches will be discussed in Chapter 3. The trust has many unique attributes which set it apart from other legal structures because these attributes create additional ways in which double taxation and double nontaxation can occur. The BEPS Action Plan only attempts to resolve double nontaxation that results from problems of attribution.

In Chapter 4, the OECD’s top-down approach to remedying hybrid-based mismatches will be examined, as well as a detailed analysis of the Action 2 Recommendations 3, 4, 5, and 6 will be conducted, which are the most relevant to trusts in cross-border mismatches. An assessment of whether these Recommendations achieve the OECD’s aims to combat hybrid mismatch arrangements generally and specifically in regard to trust-based mismatches will follow in Chapter 5.

The slow international response to and adoption of the Action 2 Recommendations will be explored in Chapter 6. Slow convergence is likely to detract from the success of the initiative. Adoption has proven particularly difficult for developing countries owing to their unique needs. South Africa straddles the line between a developing country and modern economic hub, which places the country in a natural leadership role for developing African nations.

Chapter 7 will consider alternatives to the OECD Plan that have been put forth by various scholars and have the potential to be more effective and successful. Of particular interest are Parada’s coordination-based solutions and the European Commission’s Anti Tax Avoidance Package (ATAP) which may son displace the OECD’s approach.

Scope and Methodology

This work refers exclusively to entity-based hybrid mismatch arrangements, and accordingly will not address hybrid financial instruments which are also covered in Action 2 of the OECD Action Plan. This is owing to the fact the hybrid entities and hybrid financial instruments are two highly divergent issues, and the study focusing specifically on trusts as hybrid entities. It is recognized none the less that a hybrid mismatch arrangement may involve aspects of both.

The research is not limited to a particular jurisdiction since the BEPS issue is of a global nature. There is a focus on the European Union (EU) given that the OECD Plan was primarily constructed with the experience of these jurisdictions in mind and there was very little input from states outside of this region. The study will also address the consequences for developing countries that have resulted from the EU-centric perspective of the Recommendations, with particular attention to South Africa. As such, the research may be considered an international tax law thesis.

CHAPTER 2: THE DEVELOPMENT AND AIMS OF THE BEPS ACTION PLAN

THE INTERNATIONAL TAX REGIME

The OECD defines BEPS as 'tax planning strategies that exploit gaps and mismatches in tax rules that make profits "disappear" for tax purposes or shift profits to locations where there is little or no real activity.'[7] This is not a new phenomenon: US President JF Kennedy voiced his concerns on the issue as early as 1961:

> Recently more and more enterprises organised abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices [...] in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.[8]

In the aftermath of the 2008 financial crisis, however, the tax practices of large MNEs such as Apple[9] and Google brought BEPS to the forefront of the discussion on international tax reform. In 2010 Apple attained an effective tax rate of 2.2% and in 2011 1.9%.[10] Google's effective tax rate in 2009 was reported to be only 2.4%.[11] It seems that globalisation has created the perfect conditions for BEPS practices to flourish and the corporate world has taken full advantage to maximise tax arbitrage. The extent of MNE tax avoidance was highlighted in legislative proceedings, such as the *Cadbury* case.[12]

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[7] OECD 2014b, *BEPS frequently asked questions*, see 'What is BEPS?'

[8] Saint-Amans, P & Russo, R 2013, *What the BEPS are we talking about?*, viewed 26 August 2020, <https://www.oecd.org/ctp/what-the-beps-are-we-talking-about.htm>, at para 1.

[9] European Commission 2016a, *State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion.* <https://ec.europa.eu/commission/presscorner/detail/en/IP_16_2923>. The European ommission determined that Apple employed the *double Irish sandwich* to reduce its tax burden by approximately €13 billion.

[10] Drucker, J 2010, *Google 2.4% rate shows how $60 billion is lost to tax loopholes*, viewed 26 August 2020, < https://www.bloomberg.com/news/articles/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes>

[11] Duhigg, C & Kocieniewski, D 2012, *How Apple sidesteps billions in taxes*, viewed 26 August 2020, <https://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?auth=login-facebook>

[12] *Cadbury Schweppes, plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* (2006) ECR I-7995. ECLI:EU:C:2006:544. The European Court of Justice held that freedom of establishment requires a stable and continuing economic presence in the state of incorporation. A company cannot invoke freedom of establishment in another member state for the sole purpose of benefiting from more

Media attention generated critical observation from the public, government, and non-governmental groups. It is exceptionally rare to see public outcry on matters of corporate taxation.

The political force driving the BEPS initiative is only a symptom of the deeper problem which is rooted in the establishment of the international tax regime. The concept of the international tax regime, advanced most notably by Avi-Yonah,[13] was initially viewed as controversial[14] but has gained wide acceptance. Avi-Yonah argues that a network of bilateral treaties which has definable principles that underlie it and are common to the treaties constitutes the international tax regime.[15]

In 1923 the League of Nations' Economic and Financial Commission, after identifying the growing obstacle of double taxation for international trade, issued a report[16] which became the basis of the 1928 model treaty to facilitate the reciprocal relief of juridical double taxation. The model, often referred to in the literature as the 1920's compromise,[17] became the foundation of the first model double tax agreement (DTA). No revisions or

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advantageous tax outcomes unless the establishment in the other member state entails genuine economic activity. A restriction of freedom of establishment is therefore possible in cases of a 'letterbox' or 'front' subsidiary. This appears to be a move away from *Centros* case where the company founders set up a company that had never engaged in any economic activity in its founding state and was aimed solely at avoiding Danish company law.

[13] See Avi-Yonah, RS 2000a, 'Commentary (Response to article by H. David Rosenbloom)', *Tax Law Review*, vol 53, no. 2, at pp. 167-175. Avi-Yonah, RS 2000b, 'Globalization, tax competition, and the fiscal crisis of the welfare state', *Harvard Law Review*, vol. 113, no. 7, at pp. 1573-1676. Avi-Yonah, RS 2015, 'Full circle? The single tax principle, BEPS, and the new US model', *Public Law and Legal Theory Research Paper Series,* issue paper no. 15-019. Avi-Yonah, RS & Xu, H 2017, Evaluating BEPS: a reconsideration of the benefits principle and proposal for UN oversight. *Harvard Business Law Review*, vol. 6, no. 2, pp. 185-238.

[14] Some scholars hold that the system of bilateral treaties cannot be considered customary international law due to divergences from the OECD model that persist. See Brauner, Y 2014, 'What the BEPS', *Florida Tax Review,* vol.16, no. 2, at p. 62.

[15] Avi-Yonah, R. S., 2000. Commentary (Response to article by H. David Rosenbloom). *Tax Law Review,* 53(2), pp. 167-175.

[16] League of Nations, Economic and Financial Commission 1923, *Notes and Memoranda – Report on double taxation submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Josiah Stamp, K.B.E.*

[17] See Graetz, MJ 2001, 'Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies', *Brooklyn Journal of International Law,* vol. 26, no. 4, pp. 1357-1448 for a detailed description of this period. See also Graetz, MJ & O'Hear, MM 1997, 'The "original intent" of U.S. internationl taxation', *Duke Law Journal,* vol. 46.

amendments following the introduction of this model have affected the system of international taxation to as great an extent.

The international effort to eliminate juridical double taxation was continued by the United Nations and predominantly the OECD and has found expression in a large network of some 3000 bilateral treaties. There is a strong conformity to the OECD model treaty. It is estimated that these treaties regulate approximately 85 percent of world trade and investment and as much as 75 percent of the language of all bilateral treaties is identical to that of the OECD model treaty.[18] Effectively, there is a common 'language' spoken in the world of international tax which strongly supports Avi-Yonah's argument for the existence of the international tax regime.

Source vs residence taxation has long been the elephant in the room in the discussion on tax reform. The juxtaposition of the 1920's world from which the international tax regime grew, and today's world is striking: the regime grew out of world of brick-and-mortar economies which produced immobile income. Most passive income was earned by natural persons whose residence was easily determinable. Countries elected to tax their residents – who are tied to the country – on a residence basis and foreigners on a source basis. No challenge is presented when economic activity is domestic but when cross-border transactions occur, the question of tax jurisdiction is posed. The League of Nations' framework for the taxation of cross-border transactions, which remains intact today, set out the hierarchy of taxing rights: jurisdiction would be shared amongst the relevant states and allocated on the basis of economic nexus to the income. Different types of income became subject to different distributive rates as defined by the relevant tax treaty. The treaty either grants one state exclusive taxing rights or grants one state priority while reserving a residual taxing right for the other state.

The League of Nations model favoured residence taxation. This trend was continued and strengthened by the OECD and works to the advantage of developed nations, while developing source nations were mostly excluded from the model treaty development process and left in an inferior position. While the UN model treaty aims to correct this

[18] *Ibid* 14, at pp. 61-62.

imbalance, it finds limited expression within the regime. For this reason, the OECD is viewed by many as more of a club for the wealthy nations and a reluctant leader in the BEPS process. Furthermore, given the fact that such a small group of 34 countries have attempted to regulate and keep control over the international regime, it is imperative that they achieve a successful outcome (or at least one they can declare successful), or else the OECD's dominance in the regime will surely wane, leaving room for another candidate to assume leadership – possibly the UN or the IMF.[19]

As a natural consequence of the source-residence paradigm, and with the relaxation of exchange controls in the 1980s, countries began to introduce beneficial tax rules, such as the reduction of withholding taxes, to attract foreign investment. Tax competition dominates the regime to the extent that it undermines individual and corporate income taxes,[20] which have traditionally constituted the core of state tax revenue, and forces states to increasingly depend on regressive consumption taxes. The competitive nature of the regime, in principle, forces states to resist collaboration and coordination of tax policies.[21] As a result, the necessary and fundamental changes required to bring the international tax regime up to date with the modern reality are obstructed, and the regime staggers from one perceived threat to another: from transfer pricing abuse to harmful tax practices and uncooperative tax havens, to treaty shopping and treaty abuse. In response, anti-abuse provisions are tweaked. The need to employ increasingly wider nets to 'catch' the growing number of perceived threats may have led the OECD to use extra-legal terms such as 'aggressive tax planning' instead of the traditional and internationally understood terms 'tax abuse' and 'tax evasion,' as will be discussed in more detail below.

Following the 2008 financial crisis, it became highly evident that the international tax regime has not kept pace with the changing environment of trade – even countries with the strong economies cannot effectively collect tax revenue in the current regime, as demonstrated by Avi-Yonah[22] and evidenced by the Apple and Google examples. Historically labour and capital were equally mobile but with technological advancements

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[19] Baker, P 2013, 'Is there a cure for BEPS?' *British Tax Review,* vol. 5,, at p. 606.
[20] *Ibid* 5, at p. 1576.
[21] *Ibid 18*, at p. 61.
[22] *Ibid* 5, at pp. 1573-1676.

capital is now far more mobile than labour. The system of bilateral treaties does not accurately reflect the reality of international commerce and finance, which often involves intermediary entities and the issue of favourable tax jurisdictions. The increased mobility of capital encouraged tax competition between states. The contours of the international tax regime left gaps and misalignments between tax codes. In this imbalanced and irregular environment, BEPS practices thrived.

The failings of the current competition-based structure of the international regime demonstrate the desirability of a more collaborative regime.[23] It is commendable that the OECD promised comprehensive and cohesive change that would create an international tax environment of co-operation. Such a high target is not to be easily achieved: it requires ingenious legal reform, as opposed to a reinforcement of the existing structure and rules that enable tax arbitrage to the degree that has been seen in recent times by some well-known MNEs. If the existing structure is merely reinforced, taxpayers may continue to find loopholes in this system. This is evidenced by the cycle of continuous amendments to anti-abuse legislation in most jurisdictions. Since hybrid mismatch arrangements are a common tool used by MNEs to achieve double non-taxation, they are a key focus of the OECD BEPS initiative.

KEY CONCEPTS IN THE BEPS DISCUSSION

Some key concepts of the international tax regime are incorporated into the OECD approach to BEPS. These include the single tax principle, the benefit principle the anti-discrimination principle, and the transparency principle.[24] While the OECD strives to accomplish innovative solutions,[25] these driving concepts are certainly not new since they can be traced back to Smith's *Wealth of Nations*.[26] For the purposes of this study, the single taxation principle and the benefits principle are central. These concepts respectively answer the questions:

- What is the appropriate level of taxation to be levied on cross-border transactions?

[23] *Ibid 18*, at p. 59.
[24] Avi-Yonah, RS & Xu, H 2017, Evaluating BEPS: a reconsideration of the benefits principle and proposal for UN oversight. *Harvard Business Law Review*, vol. 6, no. 2, at p. 207.
[25] *Ibid* 1, at p. 8.
[26] Smith, A 1723-1790, *The Wealth of nations*. Oxford: Bibliomania.com

- Where should the income be taxed and how should the revenue be divided between the relevant jurisdictions?[27]

The Single Taxation Principle

The single tax principle promotes that all income should be taxed only once at the rate derived from the benefits principle.[28] It can be extracted from this that the principle consists of the 'right' to be taxed only once, as well as the obligation that income is taxed at least once. Avi-Yonah proposes that the single tax principle formed the theoretical basis of the international tax regime from its very beginnings.[29]

The first clear elucidation of the single tax principle appears within the work of the League of Nations.[30] In 1927 the Committee of Technical Experts on Double Taxation and Tax Evasion presented the view that single taxation represents the balance between double taxation and tax evasion:

> From the outset the Committee realised the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international co-operation should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and only once.[31]

The single taxation principle had, however, already been employed in cross-border taxation policies, most notably, by T.S. Adams who introduced the US foreign tax credit in 1918 which prevented double taxation by granting a foreign tax credit rather than an exemption. The League of Nations model treaty depended heavily on the US approach to

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[27] De Lillo, F 2018, ' In search of single taxation?', In: Wheeler, J., ed. *Single Taxation?.* Amsterdam: IBFD. at p. 5.
[28] Avi-Yonah RS 2015, 'Full circle? The single tax principle, BEPS, and the new US model', *Public Law and Legal Theory Research Paper Series*, issue paper no. 15-019, at p. 1.
[29] *Ibid 28*, at p. 3.
[30] *Ibid* 27, at p. 8.
[31] League of Nations 1927, *Double taxation and tax evasion: report presented by the committee of technical experts on double taxation and tax evasion*, at p. 23.

the double-tax problem and Adams played an important role in the effort of the International Chamber's Double Taxation Committee.[32]

The Benefit Principle

The acceptance of the 'right' to be taxed on income only once inevitably leads to the question of where the single tax should be levied[33] and how the revenue should be apportioned between the relevant jurisdictions. The benefit principle is the concept that those who receive the benefits of government spending should contribute towards it or in other words, active income is taxed primarily at source, while passive income is taxed primarily at residence.[34] The principle embodies the notion that taxation should be levied in the jurisdiction where the value is created. The European Commission notes that ensuring taxation is applied where profits are generated is 'imperative to restore trust in the fairness of the tax systems and allow government to effectively exercise their tax sovereignty.'[35]

The coupling of value creation and taxation rights appears straightforward at first glance but it often is difficult to determine where value is created to apportion it thus. In the context of hybrid mismatch arrangement, the OECD acknowledges that 'it is often difficult to determine unequivocally which individual country has lost tax revenue.'[36] None the less, one of the key missions of the BEPS project is to align the location of taxable profits with the location of economic activities and value creation, as clarified in the OECD's *Explanatory Statement*: 'The Action Plan aims to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.'[37]

[32] *Ibid* 17, Graetz and O'hear at p. 1066
[33] *Ibid* 27, at p. 6.
[34] *Ibid* 24, at p. 188.
[35] 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, at L193/1.
[36] *Ibid 2*, at p. 23.
[37] *Ibid* 7, at p. 4.

Aggressive Tax Planning

Historically the international discussion surrounding tax abuse centred on the concepts of tax evasion and tax avoidance. Tax evasion is inherently illegal and corresponds to a tax crime or offense. It includes situations where taxpayers act against the actual purpose of the law[38] and entails a deliberate misrepresentation or concealment by the taxpayer of the true state of affairs, by means such as an incorrect tax return or sham transaction. By contrast, tax avoidance is the legal exploitation of a state's tax code to the taxpayer's advantage. Tax avoidance may imply a difference between the legal form of a structure or transaction and its substance. Consequently, the introduction of General Anti Avoidance Rules (GAAR) in many jurisdictions aims to draw a line between permissible and impermissible avoidance arrangements. None the less, the activity of tax planning has long been considered legal and is compatible with the fundamental freedom to arrange one's affairs in a tax efficient manner. The Duke of Westminster's case[39] is often cited when discussing tax avoidance schemes, where Lord Tomlin famously remarked in his opinion:

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

The political pressure in the aftermath of the 2008 financial crisis prompted the regime to respond to tax planning behaviour that, while within the constraints of the law, may endanger states' tax bases. In the context of BEPS, the OECD began to make use of the term 'aggressive tax planning.' The concept of aggressive tax planning is vague and appears to cover the terms tax evasion and tax avoidance, depending on the context –

[38] Dourado, AP 2016, 'The EU Anti Tax Avoidance Package: moving ahead of BEPS?', *Intertax*, 10 August, vol. 44, no. 6/7, at p. 441.
[39] *Inland Revenue Commissioners v Duke of Westminster*, House of Lords A.C. 1; 19 TC 490, 1936

acting as an umbrella term.[40] The term was first introduced in the OECD's 2008 Intermediaries report:[41]

> Aggressive tax planning [...] refers to two areas of concern for revenue bodies:
>
> - Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. Revenue bodies' concerns relate to the risk that tax legislation can be misused to achieve results which were not foreseen by the legislators. This is exacerbated by the often-lengthy period between the time schemes are created and sold and the time revenue bodies discover them, and remedial legislation is enacted.
> - Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. Revenue bodies' concerns relate to the risk that taxpayers will not disclose their view on the uncertainty or risk taken in relation to grey areas of law (sometimes, revenue bodies would not even agree that the law is in doubt).

Through the OECD literature that followed, the term was further refined to encompass arrangements that comply with the letter of the law but lead to very low effective tax rates.[42] It appears to be most similar to the concept of 'impermissible avoidance arrangements' which often comply with the letter of the law but violate the spirit of the law.

Panayi observes that the use of the term stems from the inappropriate insertion of the corporate social responsibility (CSR) concept into the world of tax and will lead to an uncoordinated response permeated by vague extra-legal standards, where compliance with existing tax laws is insufficient.[43] In the traditional view of the corporation, it is senseless to expect corporations to engage in CSR through the tax system. As Milton Friedman famously stated in this regard: 'There is [...] only one social responsibility of

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[40] Dourado, AP 2015, 'Aggressive tax planning in EU law and in the light of BEPS: the EC recommendations on aggressive tax planning and BEPS Actions 2 and 6', *Intertax*, vol. 43, no., at p. 44.
[41] OECD 2008, *Study into the role of tax intermediaries,* Paris: OECD Publishing. See *Glossary* at p. 87.
[42] Panayi, CHJI, 2016. International tax law in the post-BEPS world. *Bulletin for International Taxation,* November, 70(12), at p. 545.
[43] *Ibid* 42.

business – to use its resources and engage in activities designed to increase its profits'.[44] Many view this approach as outdated and extreme, however, and believe that it is in the corporation's best interest to engage in CSR thereby shifting away from immediate profit realisation to sustainable profit maximisation.[45] This approach creates a shared value for the stakeholders of the corporation with a shared purpose that will generate economic value while also addressing societal problems.[46] While certainly admirable in concept, a defining aspect of CSR is its voluntary nature. It is unreasonable to force corporations to engage in CSR through taxation by introducing legislation that requires it. The use of the term 'aggressive tax planning' has muddied the previously clear waters of tax evasion vs. tax avoidance. Particularly as it applies to hybrid mismatch arrangements, the use of the term is troubling, as it groups arrangements which may be perfectly legal and acceptable that have legitimate intent together with impermissible schemes. It is essential that a better distinction is established between legitimate tax planning and aggressive tax planning.

THE BEPS INITIATIVE AS AN AFFIRMATION OF THE SINGLE TAX PRINCIPLE

Throughout the development of the international tax regime, a focus on only one side of the single taxation principle prevailed: the elimination of double taxation. The justification for this may be that both states and their taxpayers have an interest in eliminating double taxation since it hinders trade by reducing profit, while double non-taxation only distorts the shape of trade, whereas nontaxation does not inhibit trade, only distorts its shape through tax competition.[47] From a capital importing perspective, double taxation provides a disincentive for investment in a jurisdiction. From a capital exporting perspective, the cumulative tax rates may be so high as to reduce the possibility for international trade. There has always been a strong incentive, therefore, for international co-operation with the aim of eliminating juridical double taxation.

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[44] Friedman, M 1962/2002, *Capitalism and freedom, 40th anniversary edition.* Chicago: The University of Chicago Press, at p. 132.
[45] Freedman, J 2003, 'Tax and corporate responsibility', *Tax Journal*, vol. 695, no. 2.
[46] Porter, ME & Kramer, MR 2011, 'Creating shared value: Redefining capitalism and the role of the corporation in society', *Harvard Business Review,* vol. 89, no. 1-2, pp. 62-77, pp. 62-77.
[47] Ring, DM 2002, 'One nation among many: policy implications of cross-border tax arbitrage', *Boston College Law Review*, vol. 44, at p. 105

None the less, through this focus the international tax regime that resulted is contoured by a 1920's reality and has not substantially changed to reflect a more modern reality. The bilateral paradigm through which cross-border amounts are taxed (consisting of the source state's right to tax first, and the residence state's right to tax thereafter) no longer sufficiently addresses the complexities of the international community: "The bilateral paradigm does not reflect the predominant reality of multinational tax planning today, which routinely involves use of intermediary entities located in tax favourable countries".[48]

While the degree of international co-operation in the effort to eliminate double non-taxation is yet to be fully assessed, there is an incentive for states to work towards elimination of double non-taxation: if cross-border transactions are taxed at a lower effective rate than domestic transactions, a disincentive for domestic trade and investment exists. It is easily observable though that the focus of international co-operation has shifted from the elimination of double taxation to the elimination of double non-taxation. The OECD's recent effort in this direction and the BEPS Action Plan can, therefore, be viewed as an adoption of and a firm commitment to the single taxation principle by the OECD.

There remain concerns as to the implementation of the BEPS actions.[49] The business community is rightly concerned that inconsistent implementation will result in economic double taxation. It remains to be seen if the international community adopts an anti-abuse approach, focusing on structured arrangements, or if more comprehensive approaches will develop. While comprehensive change has proved to be more effective historically, it is difficult to design and implement.

Given the strong commitment expressed, it is surprising that most discussion surrounding the single tax principle and the BEPS Action Plan focuses only on ensuring that the income is taxed once but shies away from the question of how to determine which jurisdictions have a claim to the revenue and how the revenue should be apportioned

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[48] Ault, H.J, Schon, W. & Shay, S. E. 2014, 'Base erosion and profit shifting: a roadmap for reform', *Bulletin for International Taxation*, June/July, at p. 276.
[49] *Ibid* 48, at p. 277.

between them. While the benefit principle is acknowledged as a key concern by the OECD, the recommendations do not address how its goal should be achieved.

CHAPTER 3: HOW DOES NONTAXATION OF TRUSTS OCCUR?

The tripartite structure of the trust – consisting of the settlor, trustee, and at least one beneficiary – sets it apart from other entities. An inter vivos trust is created through the donation or transfer of funds or property by the settlor to the trustee on terms which oblige the trustee to administer the assets for the benefit of the beneficiaries or for a specific purpose.[50] The assets are held in a segregated fund that do not form part of the trustee's personal estate. A trust may also be a discretionary or vesting trust: whereas in a vesting trust the beneficiaries have vested rights in the assets or income, a beneficiary in a discretionary trust only has a contingent right and obtains a vested right in the assets or income once the trustees exercise their discretion to vest the asset or income in him. The trustees of a discretionary trust may elect rather to accumulate the funds in the trust to later distribute to members of the class of beneficiaries. It can therefore be more difficult to determine the tax outcomes of a transaction involving a trust owing to its structure. The legalisation governing the taxation of trusts differs between jurisdictions, leading to further complications in cross-border transactions involving trusts. Such complication may lead to either the double taxation or double non-taxation of transactions.

DISTINCTIVE TAX CHARACTERISTICS OF TRUSTS

Brabazon[51] identifies a number of distinctive tax characteristics of trusts which contribute to the occurrence of double taxation or nontaxation:

- settlor attribution;
- differential transparency;
- item allocation;
- entity classification;
- internal coherence;
- trust residence; and

[50] De Koker, AP & Williams RC 2019, *Silke on South African Income Tax.* Johannesburg:LexisNexis South Africa, at §12.19.
[51] *Ibid 6*, at pp. 212-214.

- distribution taxation.

Settlor Attribution

Brabazon refers to this as *grantor attribution*, using the US term for settlor for which the terms testator or founder can also be employed. Since there is no equivalent of the settlor when comparing the trust to other types of legal entities, the provisions relating to the taxation of the settlor are a common factor in a double taxation result. Many countries attribute the income of trusts to the settlor instead of the trust itself. Some countries, including South Africa, extend settlor attribution to include income accruing to foreign trusts (i.e., outbound situations). In the South African context, section 7(8)(a)[52] specifies that to the extent that any amount accrues to a foreign trust as a result of a donation by a South African resident, which would have constituted income had the trust been a resident, then that amount is subject to tax in the hands of the settlor for local tax purposes.

Differential Transparency

While the tax treatment of the trust is guided by established principles dating back to Adam Smith's *Wealth of Nations*, it is possible to arrive at different interpretations of these principles. As a result, the tax treatment of the trust differs from country to country. Common law jurisdictions usually assess trust taxation under a 'hybrid' tax model.[53] Within a given jurisdiction, the trust may be transparent for some income, but opaque for the remaining income. Trust income may be attributed to the settlor, the beneficiaries, or the trust itself. The trust becomes liable for taxation on any amounts not attributed to the settlor or beneficiaries but the criteria by which attribution is determined differ between jurisdictions. In civil law jurisdictions, the topic of trust taxation is less evolved, and the question of fiscal attribution is usually resolved through the adaptation of trust components to civil law concepts. Adding to this is the fact that no single definition of income commands universal assent: an amount may be deemed income in one jurisdiction and capital in another.

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[52] Income Tax Act (Act No. 58 of 1962), section 7(8)(a).

[53] Danon, RJ 2004, 'Conflicts of Attribution of Income Involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report', *Intertax*, vol. 32, no. 5, at p. 211.

Item Allocation

The provisions governing the attribution of income amongst beneficiaries or between the trust and a beneficiary may differ between jurisdictions and between the types of trust within a single jurisdiction. In most jurisdictions, priority is accorded to the taxation of the settlor, which supersedes attribution to the trust of its beneficiaries.[54] However, in selected jurisdictions, settlor attribution may be displaced by beneficiary attribution in cross-border contexts.[55]

Entity Classification

The definitions relating to entity classification differ amongst jurisdictions. A trust in jurisdiction A may not meet the definition of a trust in jurisdiction B. This frequently applies to business trusts. For example, foreign business trusts are taxed as corporations or partnerships in the United States because they engage in active trade or business and are 'simply [used] as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code.'[56] The reverse may also occur where an entity that is classified as a partnership in jurisdiction A is classified as a trust in jurisdiction B.

Internal Coherence

The intersection of two areas of law often results in complexities. For example, when a beneficiary of a trust receives a trust distribution resulting from a foreign dividend received by the trust, the jurisdiction's provisions relating to the inbound taxation of dividends and those relating to the fiscal attribution of trust income intersect. It is essential that the components of a country's tax code work coherently. Where the intersection of two bodies of law results in different tax consequences owing to the insertion of a trust,

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[54] Brabazon, M, 2019. *International taxation of trust income: principles, planning and design.* Cambridge: Cambridge University Press, at p. 261.

[55] For example, New Zealand's rules for the taxation of trusts, often referred to as the 'settlor regime', attribute a foreign trust's worldwide income to the New Zealand resident settlor of that trust. The attribution of income to the settlor is superseded by attributions to the beneficiaries which do not form part of the assessable income. In other words, the regime only affects income that is not attributed to a beneficiary, making settlor attribution secondary. See ITA NZ s BD 1(4), (5)(c).

[56] IRS Regs. §301.7701-4(b).

the internal coherence is lacking. For example, a non-resident individual who invests directly may be liable for a different level of taxation than a non-resident beneficiary that invests through the vehicle of a trust due to a lack of uniformity between the source country's tax provisions. It is in a jurisdiction's interest to ensure uniformity, but the reduction of international taxation only results if the investor jurisdiction in turn does not attribute the income to the beneficiary in addition. The investor jurisdiction may be a source-based taxation jurisdiction or attribute the income to attribute the income to a non-resident settlor.

Trust Residence

The rules governing the residency of trusts differ between jurisdictions. A trust may therefore be considered resident in multiple jurisdictions or in no jurisdictions, making it homeless with no fiscal residence: 'It is not the case that each country points to another as the residence, but that each country answers the binary question "Is this trust resident or non-resident" here? In the negative.'[57] Jurisdictions may refer to a number of factors in determining whether a trust is liable for tax, including the residence of the settlor, the residence of the trustees, the place of management or control, the proper law of the trust, and/or the situs of the assets. It is highly likely that a trust will not be purely domestic as it becomes increasingly easy for trustees, settlors, and beneficiaries to relocate. In civil law countries, the proper law of a trust is bound to be foreign, and it can be assumed that there is a foreign element. Consequently, double taxation or double non-taxation may occur: a trust that is resident in multiple jurisdictions is exposed to double taxation, whereas a homeless trust may be used to achieve double non-taxation or long-term deferral.

Distribution Taxation

A mismatch between the taxation of trust-level current income and the taxation distributions to a foreign beneficiary may result in double taxation or non-taxation. Double taxation may result if the trust income is taxed at a relatively high rate and the rate of taxation of the distribution is not taken into account. Non-taxation may result if

[57] *Ibid* 54, at p. 158.

the trust-level income is taxed at a relatively low rate and the distribution income is not recognised as income.

CONFLICTS RESULTING FROM DISTINCTIVE TRUST CHARACTERISTICS

As is clear from the above, a mismatch does not need to involve a tax haven in order to produce beneficial tax treatment.[58] The aforementioned distinctive trust attributes lead to conflicts that may result in the double taxation or nontaxation of a trust and it is necessary to consider how jurisdictional tax legislation applies to cross-border transactions. Additionally, not all hybrid arrangements give rise to mismatches and an essential first step in mending unwanted mismatches is to identify which mismatches give rise to inconsistent outcomes.[59] The contributing trust attributes can be grouped into 3 types of conflicts: conflicts of attribution; conflicts of residence; and conflicts of distribution taxation.

Conflicts of Attribution

These conflicts may result from settlor attribution differential transparency, item allocation, and entity classification. Given the divergence of rules which a jurisdiction may implement, it is foreseeable that conflicts of attribution are likely to occur in cross-border transactions. In each of these cases, there is a conflict regarding the taxation of same current-level income for the identical period. All countries that could potentially tax the current income of the trust attribute the income to different non-resident persons or entities and a negative attribution conflict arises. The attributes may also apply concurrently. While it is difficult to determine which jurisdiction loses tax revenue (as will be discussed in depth in chapter 5), it is clear that deliberate utilisation of these attributes to lower the effective tax rate qualifies as tax arbitrage and it is this type of hybrid entity mismatches that the OECD aims to remedy with the recommendations contained in Action 2.

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[58] Harris, D 2016, 'International tax implications of the Organisation for Economic Co-operation and Development proposal to neutralize hybrid mismatch arrangements', *Catholic University Law Review,* vol. 65, no. 3, at p. 3.
[59] *Id*

While internal coherence falls into this category, the mismatch that results is local, not cross-border. It is therefore not a concern for the OECD. Brabazon notes that utilisation of internal coherence mismatches may be considered tax avoidance in the given jurisdiction.[60]

Conflicts of Residence

Mismatches of this nature are 'global rather than binary'.[61] If the connections that link a trust to a jurisdiction are distributed in such a way that no jurisdiction claims the right to tax the trust, it would be difficult to say that any jurisdiction loses out on tax revenue. Perhaps the beneficiary jurisdiction to some degree since a homeless trust is often associated with long-term deferral. Given that the nature of conflicts of residence are non-binary, the Action 2 does not target these conflicts. As explored further in chapter 5, the limited scope of the BEPS Action Plan will likely reduce its successfulness.

Conflicts of Distribution Taxation

The form of double taxation and double non-taxation of trust income is not strictly juridical in nature but rather economic: the same income may be taxed in the hands of *different* taxpayers in two separate jurisdictions.[62] DTAs, which are aimed at solving conflicts of residence, do not grant relief for trust distributions for this reason. A mismatch may occur because a jurisdiction which enacts a high rate of current taxation assumes that low or no distribution tax. Whereas a jurisdiction that enacts a high distribution tax does not recognise the rate at which the income was taxed in the trust jurisdiction.[63]

SUMMARY OF DISTINCTIVE TRUST ATTRIBUTES AND RESULTING CONFLICTS

The conflict types, contributing distinctive trust attributes and the possible resulting mismatches are summarised below in Table 1. Action 2 of the OECD final report focuses largely on mending reverse hybrid mismatches that result from the first four distinctive

[60] *Ibid 6*, at p. 214.
[61] *Ibid 6*, at p. 215.
[62] *Ibid 53*, at p. 215.
[63] *Ibid 6*, at p. 215.

trust attributes discussed: settlor attribution; differential transparency; item allocation; and entity classification.

Table1: Summary of Distinctive Trust Attributes and Resulting Conflicts

Type of Conflict	Contributing Attribute	Possible Mismatch Result
Conflict of Attribution	Settlor Attribution Differential Transparency Item Allocation Entity Classification	Reverse hybrid mismatch
	Internal Coherence	May lead to under or over taxation but not necessarily as a result of a mismatch.
Conflict of Residence	Trust Residence	Can create indefinite deferral but no mismatch exists.
Conflict of Distribution Taxation	Distribution Taxation	Tax liability in the beneficiary state may be affected but no clear mismatch exists.

TRUSTS AS REVERSE HYBRID ENTITIES

A hybrid entity is an entity that is seen as opaque in its jurisdiction of incorporation and as transparent in the investor's jurisdiction.[64] While a *reverse hybrid entity* supposes exactly the opposite situation. It is defined in the OECD's Action 2 Report as 'any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction'.[65] A more comprehensive construct it is:

> An entity that is transparent where entity-level income would be taxable to it (assuming attribution) on a residence or similar basis if the entity were opaque, and

[64] OECD, *Glossary of Tax Terms*, viewed 23 February 2021, <http://www.oecd.org/ctp/glossaryoftaxterms.htm>
[65] *Ibid 3*, at p. 55.

> opaque where such income would be taxable to someone else (assuming attribution) if the entity were transparent[66]

The concept of transparency is not defined by the OECD, but is explained with reference to income:

> A person will be treated as tax transparent in respect of a payment where the reverse hybrid attributes or allocates a payment that it has received to an investor and the effect of such attribution or allocation under the laws of the establishment jurisdiction is to treat the payment as it would have been treated had it been paid directly to that investor.[67]

A hybrid entity mismatch is 'an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax'.[68] Hence, there are 3 elements necessary to trigger a reverse hybrid mismatch: (i) a disparity in the characterization of an entity by the jurisdictions involved; (ii) a payment between two persons involved in the hybrid entity structure and part of the same control group; and (iii) a deduction/non-inclusion or double deduction result.[69]

In practical terms, consider the scenario below (Figure 1). A trust (T) is formed in jurisdiction D with a settlor (S) who is resident in jurisdiction E and beneficiaries (B) in jurisdiction F. The settlor remits income to the trust and the trustees of the trust choose to distribute the assets to the beneficiaries. Jurisdiction D treats the trust as transparent with regards to this type of income, while jurisdiction F treats the trust as opaque. It makes no difference whether the jurisdictions view the trust as completely opaque or transparent, only how they treat the trust with regard to this particular type of income.

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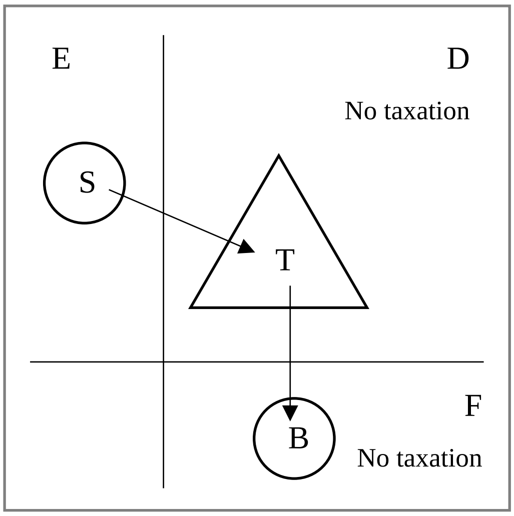
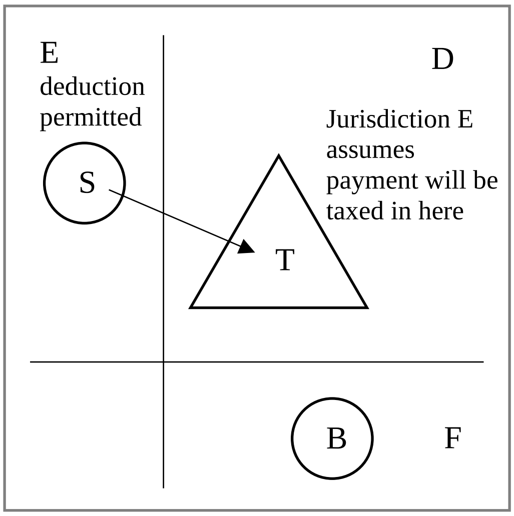
[66] *Ibid 6*, at p. 217.
[67] *Ibid* 3, at p. 56 para. 140.
[68] OECD 2014f. *Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws).*
[69] Parada, L 2018b, 'Hybrid entity mismatches and the international trend of matching tax outcome: a critical approach', *Intertax.* vol. 46, no. 12, at p. 972.

Figure 1: Result of a Reverse Hybrid Mismatch



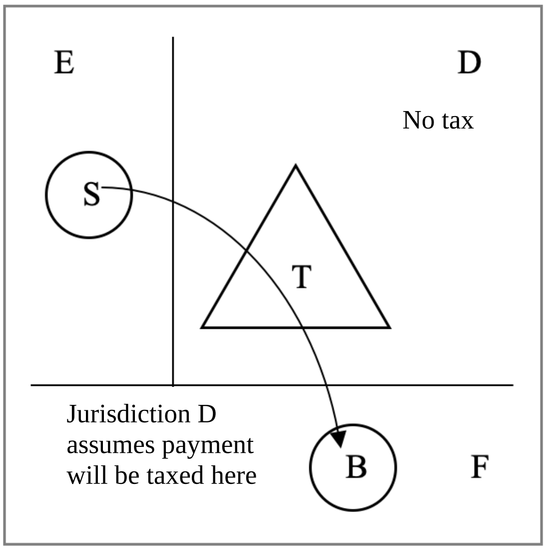
The trust may constitute a reverse hybrid entity, causing a mismatch to result. From jurisdiction E's point of view (illustrated in Figure 2) the settlor simply remits income to the trust. No further transaction is seen, and the settlor is entitled to deduct the payment from his income. Jurisdiction E does not consider whether the amount goes untaxed in jurisdiction D or F.

Figure 2: Mismatch from the Payer Jurisdiction Point of View



From jurisdiction D's point of view (illustrated in Figure 3), the trust receives income from the settlor and distributes said income to the beneficiaries. Since the trust as treated as transparent with regard to this type of income, no tax consequences are triggered in jurisdiction D.

Figure 3: Mismatch from the Establishment Jurisdiction's Point of View



In jurisdiction F, the trust is opaque with regard to this type of income, and it assumes that the income is taxed in jurisdiction D. The income is therefore untaxed in the hands of the beneficiaries and a double non-taxation result occurs.

For a mismatch to occur, it is as necessary condition that the entity is transparent in the *establishment jurisdiction* and be treated as a separate entity by the *investor jurisdiction*. In the example discussed above, the settlor's jurisdiction is separate from the jurisdiction in which the trust was formed but the terms *establishment jurisdiction* and *investor* are not commonly employed in relation to trusts. Therefore, it necessary to understand how the OECD defines these terms.

Establishment Jurisdiction

The following definition is provided for establishment jurisdiction in chapter 2 of the Action 2 Report: 'Establishment jurisdiction, in relation to any person, means the jurisdiction where that person is incorporated or otherwise established'.[70] Since a trust is not incorporated, the concept of establishment jurisdiction was introduced.[71] While a trust

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[70] *Ibid* 3, at p. 122.
[71] *Ibid 6*, at p. 219.

can be said to be resident in that jurisdiction[72] if it differentially transparent, this is not the case if it is wholly transparent. The OECD specifies that 'For entities such as partnerships or trusts that may not require formal registration, this will be the jurisdiction under whose laws the entity is created or operates'.[73] However, there is still room left for dispute. The jurisdiction in which a trust is created or operates may be argued to be one of a number of jurisdictions.

Brabazon notes that this definition is lacking in that none of the options presented as a means to determine the establishment jurisdiction (the country under whose legal system the trust was historically created; the country whose legal system serves as the governing law of the trust; and a country whose courts can exercise primary judicial supervision of the trust) is entirely satisfactory as they do not necessarily result in the fiscal residence of the trust.[74] Furthermore, the goal is not to interpret the recommendations, but to determine how they can be enacted. He suggests that it would be more prudent to adopt the approach that the establishment jurisdiction refers to the jurisdiction where a trust is or would be liable for taxation since countries already have rules for determining this.

Proper Law as the Determinant

One may argue that the proper law of the trust indicates the jurisdiction in which a trust is created or is liable for taxation. The Hague Convention on Trusts[75] imposed an obligation on all states to recognise trusts whether or not their legal system grants them existence. The Convention stipulates that the trust shall be governed by the law chosen by the settlor.[76] The choice principle is subject to Article 5 which states: 'The Convention does not apply to the extent that the law specified by Chapter II does not provide for trusts or the category of trusts involved'. It has very little scope since it is highly unlikely that a trust is most closely connected to a legal system which does not recognize trusts or the specific type of trust.

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[72] See *CIR v Jagger & Co (Pty) Ltd* (1945) CPD 331, 13 SATC 430 and *Nathan's Estate v CIR* (1948) (3) SA 866 (N), 15 SATC 328 which expanded the typical definition of a 'person' and established that a legal entity such as a trust are capable of being resident in a jurisdiction.
[73] *Ibid 3*, at p. 126.
[74] *Ibid 6*, at pp. 221-222.
[75] Hague Conference on Private International Law 1985, *Convention on the law applicable to trusts and on their recognition.*
[76] *Ibid* 75, note 3 of article 6.

Article 13 is permissive in nature, allowing courts to withhold recognition of a 'trust that the significant elements of which, except for the choice of the applicable law, the place of administration and the habitual residence of the trustee, are more closely connected with States which do not have the institution of the trust or the category of trust involved'. It would not make sense if the place of administration of the trust and the jurisdiction of residence of the trustees may be disregarded and displaced by the proper law of the trust. The former is objective in nature, unlike the proper law which in theory may be changed by the settlor to migrate the trust to another jurisdiction.[77] None the less, article 13 is only permissive and so it may not have much weight. While the concept of migration of trusts was once so unheard of that a trustee would be called to account for his failure to weigh the advantages of migration against the disadvantages, it is now ordinary for a trust to be migrated to avoid threats to its assets by governmental impositions.[78]

There is some divergence in the way countries have adopted these articles.[79] Italy allows the establishment of trusts. That would otherwise be Italian trusts, elsewhere if the settlor desires to accomplish goals out of the reach of Italian law.[80] Swiss legislature removed the option not to recognize a trust that falls within Article 13 from the courts, giving a wide latitude to the choice principle.[81] While the UK simply omitted article 13 from its legislature removing the option not to recognize trusts that fall within article 13. This seems to have been a mistake and misunderstanding of the scope of article 13.[82] In the case that a court deems the proper law of a trust not to be the determining factor of residence, the court must determine to which jurisdiction a trust is most closely connected by applying a set of objective factors.[83]

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[77] See Matthews, , P 1997, 'Trusts: Migration and Change of Proper Law', London: *Key Haven Publications*, for the common law principles relating to the migration of trusts.
[78] Hendrickson, RA & Silverman, NR 2003, 'Changing the Situs of a Trust', New York: *Law Journal Press*, loose-leaf. The authors suggest clauses for trust deeds to allow for migration and examines state statutes regarding trust migration and court reactions to petitions for change.
[79] Smith, L 2013, 'Stateless trusts', In: *The worlds of the trusts.* Cambridge: Cambridge University Press, pp. 89-100.
[80] Graziadei, M 2012, 'Recognition of Common Law Trusts in Civil Law Jurisdictions Under the Hague Trusts Convention With Particular Reference to the Italian Experience' in L. Smith (ed.), *Re-imagining the Trust: Trusts in Civil Law*. Cambridge: Cambridge University Press, at note 5.
[81] Swiss legislature brought into force the whole Convention, including art. 13, and then enacted as a matter of Swiss law that the option given by art. 13 was not to be exercised by Swiss courts.
[82] *Ibid* 79, at p. 93.
[83] *Ibid* 75, at note 3, article 7.

The choice of law principle is recognized in common law. In *Augustus v The Permanent Trustee Co*[84] the Austrian High Court found no objection to the settlor having chosen the proper law of New South Wales. However, as illustrated in *Schmidt v Rosewood Trust Ltd*,[85] a court of equity which has jurisdiction over the general administration of a trust in matters such as the removal and instatement of trustees, has inherent jurisdiction and would supersede the jurisdiction chosen by the settlor. In a United States case *B. W. Jones Trust v Commissioner of Internal Revenue*,[86] despite the fact that the trust was governed by English law, it was found to be resident in the United States. Therefore, while the proper law may be a strong indication of the residence of a trust, it is not universally accepted as the determining factor and may be superseded by other more objective factors.

Trustee's Place of Residence as the Determinant

Contrary to the definition of establishment jurisdiction provided in chapter 12, in chapter 4 the trustees' place of residence is accorded greater importance:

> The establishment jurisdiction will, in the case of entities that are formed by incorporation or registration, be the jurisdiction where that person is registered or established. For entities that can be formed without formal incorporation or registration requirements (such as partnerships and trusts) the establishment jurisdiction will be the jurisdiction under which the entity has been created and/or where the directors (or equivalent) perform their functions.[87]

In chapter 12, the term director is expanded to include any person who has control over the decision-making processes, which would include the trustees.[88] It seems to follow that this should extend to others with decision-making power such as the protector or settlor, it is unclear whether that is the intention. Contrariwise, in *Gómez v Gómez-Monche*

[84] *Augustus v. Permanent Trustee Co. (Canberra) Ltd*. (1971) 124 CLR 245, at p. 259-267.
[85] *Schmidt v Rosewood Trust Ltd* [2003] 2 AC 709 (Privy Council (Isle of Man)), at 729 [51].
[86] *B. W. Jones Trust v. Commissioner of Internal Revenue*, 46 BTA 531 (1942), aff'd., 132 F.2d 914 (4th Cir. 1943).
[87] *Ibid* 3, at p. 59.
[88] *Ibid* 3, at p. 121.

Vives[89] the court found that the term trustee, with reference to the trustee's place of residence as a determining factor, employed by the Hague Convention on Trusts should be restrictively construed and does not extend to any other person with fiduciary powers.

The trustee's place of residence condition is congruous with that the place of effective management (POEM) concept employed in regard to corporations. This factor is used by a number of jurisdictions to determine whether a trust can be said to be resident in the jurisdiction and thus subject to taxation there. For example, Australia uses the central control and management as an alternate directive for determining trust residence.[90] The trustee's place of residence is used in the UK as well to determine trust residence: if all trustees are UK resident or any trustee is resident and the settlor was resident at the time of settlement, the trust is deemed to be resident in the UK.[91]

One obstacle to this method is that the concept of trustee residence is obviously not well developed in civil law countries. In the Netherlands, Italy, and Germany, trust residence is determined by analogy with corporate entities and the place from which the trust activities and operations are carried out will determine its residence.[92] Whereas in Germany a trust will most likely be treated as a family foundation or other unincorporated entity, but the principal place of management will still determine the residency of the trust.[93]

Place of Residence of the Settlor as the Determinant

New Zealand's method for determining the residence of a trust is strikingly different. The main determining factor used to assess residence for the purposes of current taxation[94] is the current residence of the settlor.[95] New Zealand legislature views the trust as an economic agent of the settlor. The settlor regime has motivated other jurisdictions to

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[89] *Gomez and others v Encarnacion Gomez-Monche Vives and others* (2008) EWCA 259 (Ch), 3 WLR 309.
[90] See ITAA 1936 s.95(2)(b)
[91] See ITA UK s 476; TCGA s 69(2B), (2C)
[92] Avery Jones, J F et al. 1989, 'The treatment of trusts under the OECD Model Convention: Part 1', *British Tax Review*, vol 2, at p. 44.
[93] *Ibid* 92, at p. 44.
[94] The term resident is not used with reference to a trust in New Zealand tax law.
[95] ITA NZ s HC 25(2)

implement settlor attribution rules.[96] While this rule is objectively the least manipulable of the trust residence rules, conflicts of residence are bound to result from clashes with rules of other jurisdictions of trust residence. Therefore, it would not be practical to use this rule in conjunction with the Action 2 recommendations.

Investor Jurisdiction

The definitions relevant to the term investor jurisdiction can be found in chapter 12 of the Action 2 Report:[97]

> *Investor jurisdiction*: Any jurisdiction where the investor is a taxpayer.
>
> *Investor*: Investor, in relation to any person, means any person directly or indirectly holding voting rights or equity interests in that person.
>
> *Voting right*: Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.
>
> *Equity interest*: Equity interest means any interest in any person that includes an entitlement to an equity return.
>
> *Equity return*: Equity return means an entitlement to profits or eligibility to participate in distributions of any person and, in respect of any arrangement is a return on that arrangement that is economically equivalent to a distribution or a return of profits or where it is reasonable to assume, after consideration of the terms of the arrangement, that the return is calculated by reference to distributions or profits.

It follows that the following persons may be included under the umbrella of the term investor:

- Any person who has decision-making rights regarding the trust assets, including:
  - A trustee who has the power to distribute trust assets or amend the trust deed;
  - A settlor in the instance of a revocable trust; and

[96] *Ibid* 54, at p. 106.
[97] *Ibid* 3, at pp. 121-123.

    - A protector who has control or influence over the actions of the trustees.
- Any person who is entitled to profits or distributions from the trust, including:
    - A beneficiary of the trust; and
    - A settlor who is also a beneficiary or may be eligible for a return of profits.

Concisely put, an investor is a person may potentially benefit from or control the trust.

Inevitably, a trust that is differentially transparent in any investor's jurisdiction would classify as a reverse hybrid entity since the trust is by definition a separate person for tax purposes. Irrespective of how the trust's income is attributed, or which jurisdiction(s) can claim taxing power, the trust is still a separate entity from its investors and any cross-border transaction may result in a reverse hybrid mismatch.

CHAPTER 4: RECOMMENDATIONS ADDRESSING REVERSE HYBRID MISMATCH ARRANGEMENTS

COMPOSITION OF THE OECD BEPS ACTION PLAN

The BEPS Action Plan is set out into 15 action items and was endorsed by the members of the G20 at the G20 at the Saint Petersburg summit in 2013. The members view the BEPS Action Plan as a means to ensure international tax fairness: "In an increasingly borderless world, strengthening international co-operation in tax matters is essential to ensuring the integrity of national tax systems and maintaining trust in governments."[98]

The action items of the BEPS Action Plan may be generally categorised as follows:[99]

Table 2: BEPS Action Items

Action Number	**Focus**
Action 1	Rules for the digital economy
Action 2 – 6	Prevention of double non-taxation
Action 7 – 10	Alignment of economic activity and taxation
Action 11 – 14	Tax transparency and dispute resolution
Action 15	Efficient and effective implementation

This paper will focus on Action 2 of the plan which addresses mismatches that result from hybrid instruments. Action 2 is by far the longest of the Action Items, spanning some 458 pages and making it the most comprehensive, complex and difficult to implement of the

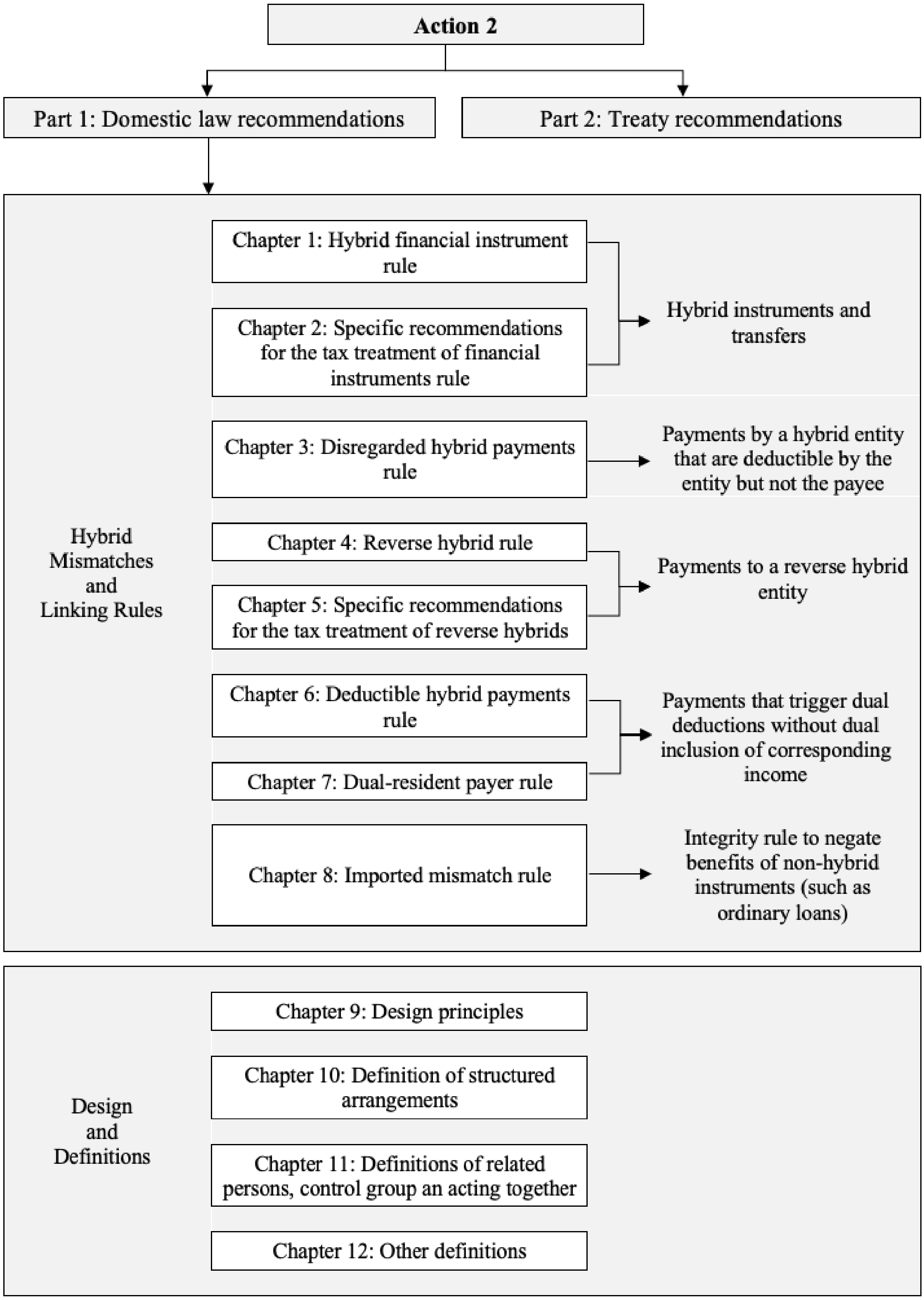
[98] G20 2013. *Tax annex to the St. Petersburg G20 Leaders' Declaration*, at p. 2.
[99] *Ibid* 48, at p. 275.

15 Action Items.[100] Part I of Action 2 presents recommendations for domestic law and Part II recommendations for DTAs.

As summarised in Figure 4 below, chapters1 though 8 address different types of hybrid mismatches. Hybrid instruments and transfers are address in chapters 1 and 2. Payments by hybrid that result in a deduction/non-inclusion (D/NI) tax consequence are addressed in chapter 3. Payments to reverse hybrid entities are addressed in chapters 4 and 5. Payments that result in double deductions and without dual inclusions of the corresponding income are addressed in chapters 6 and 7. Lastly chapter 8 addresses imported mismatches or the use of non-hybrid instruments, such as ordinary loans, to shift the effect of an offshore hybrid mismatch to a domestic jurisdiction. For the most part, these chapters pose a two-level domestic solution: a primary response to be executed in the payer jurisdiction and a defensive rule to be executed in the payee jurisdiction. Together these are known as *linking rules*.[101] Chapters 9 through 12 provide a description of the recommendation design approach and the definitions.

[100] Kuźniacki, B et al. 2017, 'Preventing tax arbitrage via hybrid mismatches: BEPS Action 2 and developing countries', *WU International Taxation Research Paper Series*, vol. 3, at p. 5.
[101] *Ibid 69*, at p. 979.

Figure 4: Composition of the Action 2 Report



Chapters 4 and 5 include recommendations that potentially affect the taxation of trust income in circumstances where the trust behaves as a reverse hybrid entity. These recommendations will be explored in depth below. Chapters 3 and 6 contain recommendations that could hypothetically apply to trusts, although in quite rare circumstances. The recommendations are terse and drafted to resemble a statute.[102] It is necessary to review the definitions set forth in the chapters 10 through 12 to gain a thorough understanding of the recommendations.

BOTTOM-UP AND TOP-DOWN APPROACHES

The OECD adopted a bottom-up approach with the intent of simplifying the application and administration of the recommendations. [103] A *bottom-up* approach seeks to distinguish structures that involve the most critical concerns for tax policy – those that are intended to take advantage of legislative mismatches to achieve tax benefits. [104] Thenceforth, the recommendations address how to rectify unwanted mismatch results. A justification for this approach is provided in the executive summary:

> Overly broad hybrid mismatch rules may be difficult to apply and administer. Accordingly, each hybrid mismatch rule has its own defined scope, which is designed to achieve an overall balance between a rule that is comprehensive, targeted and administrable.[105]

The disadvantage to this approach is the possibility of some types of mismatches escaping the net of Action 2. [106]

In theory, a detailed and effective plan based on the bottom-up approach would require identification and thorough comprehension of the core elements of the hybrid elements that contribute to mismatches. As will be discussed in chapter 5, the OECD's plan fails exceptionally in this capacity. The Action explores the double non-taxation effects and particular situations which result in mismatches but the fundamental principles that

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[102] *Ibid 6*, at p. 217.
[103] *Ibid* 3, at p. 67, para. 119.
[104] *Ibid* 58, at p. 652.
[105] *Ibid* 3, at p. 16, para. 21.
[106] Pleskova E 2014, 'Can OECD initiatives eliminate or migrate hybrid financial instruments tax effects? And what can be proposed as alternative solution?' Tilburg: Tilburg University., at pp. 20-21.

constitute a hybrid or reverse hybrid entity are not addressed. The recommendations effectively only confront the mismatch results and are consequentialist in nature.[107]

The alternative to this approach would have been the *top-down* approach, wherein all hybrid mismatches would automatically qualify as undesirable, and from there, certain exceptions would be given exception.[108] While this approach is certainly more extensive, it would risk unfairly including mismatches that contravene the spirit of the law and making compliance arduous for taxpayers.

Important Concepts and Definitions

Deduction/Non-Inclusion Outcome

When a payer deducts a payment from his income in jurisdiction A and a non-resident payee is not liable for tax on the income in jurisdiction B the resulting mismatch is a deduction/non-inclusion (D/NI) mismatch. Recommendation 12 specifies that:

> A D/NI outcome is not generally impacted by questions of timing in the recognition of payments or differences in the way jurisdictions measure the value of that payment. In some circumstances however a timing mismatch will be considered permanent if the taxpayer cannot establish to the satisfaction of a tax authority that a payment will be brought into account within a reasonable period of time.[109]

Dual Deduction Outcome

When a payment is deductible under the laws of more than one jurisdiction, it triggers a dual deduction (DD) outcome.[110]

[107] *Ibid* 69
[108] *Ibid* 3, at p. 33.
[109] *Ibid* 3, at p. 121.
[110] *Ibid* 3, at p. 121.

Structured Arrangement

Hybrid mismatch rules apply only to persons within a structured arrangement. Recommendation 10 provides the definition for s structured arrangement:

> Structured arrangement is any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.[111]

The following indicators may be used to identify a structured arrangement:

- The arrangement or a step in the arrangement creates a mismatch;
- The arrangement is marketed to produce a tax benefit;
- The arrangement is marketed to taxpayers as producing a tax benefit;
- The arrangement is marketed to taxpayers as a jurisdiction which the mismatch will arise;
- The terms of the agreement alter in the event that a mismatch can no longer be achieved; or
- The arrangement would not produce a tax benefit without the inclusion of the hybrid element.

The structured arrangement definition is intended to limit the scope of the rules to circumstances where the person has a reasonable amount of knowledge of the mismatch and intends to lower the aggregate tax rate for the transaction involved. However, the test for a structured arrangement is objective:[112] Regardless of the party's intention, if the facts surrounding the arrangement indicate that beneficial tax outcomes are an intended feature of the arrangement. A person may only be considered not party to the arrangement if he could not be reasonably expected to have been aware of the mismatch result.

[111] *Ibid* 3, at p. 105.
[112] *Ibid* 3, at p. 106.

Control Group

In Recommendation 11 of Action 2, a control group is defined as follows:

> Two persons are in the same control group if:
>
> i. they are consolidated for accounting purposes;
> ii. the first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provides that person with effective control over both persons;
> iii. the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or
> iv. they can be regarded as associated enterprises under Article 9.[113]

In simpler terms, parties are treated as members of a control group if they form part of the same consolidated group for accounting purposes or one person has effective control of the other person or a third person has effective control over both persons i.e., sister entities.

No definition is provided for the term *effective control* but it implies that the legal right to control is not a prerequisite and he control aspect need not be absolute.[114] At first glance it may seem clear that the trustees yield control of a trust with exception to all other parties, but in practice the settlor, protector and even beneficiaries may hold the power to remove and replace the trustee – a power which in and of itself bestows effective control. In fact, Action 2 makes very sparse mention of trusts with an example illustrating the control group test as one of them:[115] where a settlor retains the right to replace the trustee, he automatically holds 100% of the voting rights. Additionally, the voting rights extend to each member of the settlor's family since they will be considered to be *acting together*.

The concept of the control group is an essential facet as a payer may not be aware of the mismatch implications of a transaction and derive no benefit from the results: 'The mechanics of reverse hybrid structures also make it difficult for any party to the arrangement to know the nature and extent of the mismatch unless the arrangement is

[113] *Ibid* 3, at p. 113.
[114] *Ibid 6*, at p. 228.
[115] *Ibid* 3, Example 11.1 at p. 445.

implemented within the confines of a controlled group.'[116] It would be unfair to penalise an uninvolved party.

Acting Together

> Two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:
>
> a) they are members of the same family;
> b) one person regularly acts in accordance with the wishes of the other person;
> c) they have entered into an arrangement that has material impact on the value or control of any such rights or interests; or
> d) the ownership or control of any such rights or interests are managed by the same person or group of persons.[117]

Undoubtedly, the dealings of a trust will often be considered to be carried out by persons who are acting together.

RECOMMENDATION 4: DENIAL OF PAYER DEDUCTION

Chapter 4 addresses payments to a reverse hybrid entity which result in a D/NI mismatch. Recommendation 4 calls on the jurisdiction of the payer to reverse the deduction to the extent of the mismatch, where 'The extent of a mismatch is determined by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises'.[118] There are two conditions necessary to trigger the rule:

1. The mismatch result must be attributable to the hybrid entity. Meaning that the income would have attracted full taxation had it accrued to the investor directly.[119] As a contrasting illustration, if the investor is a tax-exempt entity, the

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[116] Ruchelman, SC 2014, 'Neutralizing the effects of hybrid mismatch arrangements: the new OECD discussion drafts regarding base erosion and profit shifting', *Journal of Taxation and Regulation of Financial Institutions*, vol. 27, no. 5, at p. 33.
[117] *Ibid* 3, at p. 113.
[118] *Ibid* 3, at p. 17.
[119] *Ibid* 3, at p. 60.

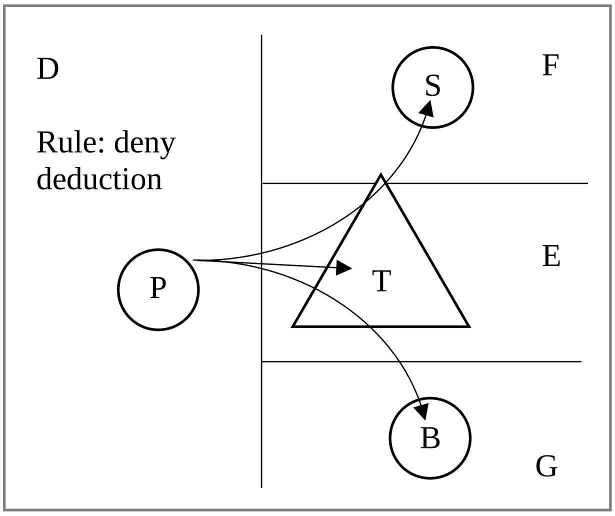
income would not have been subject to tax and recommendation 4 is not triggered.[120]

2. The payment is made under a *structured arrangement* or the investor, the entity, and the payer are part of the same *control group*.[121] This condition is of tantamount importance since it aims to limit the application of the rule to transactions of which the payer has actual interest or knowledge.[122]

This recommendation is aimed at mending conflicts which arise from negative attribution (as discussed in chapter 3): the establishment jurisdiction attributes the income to non-resident investors but the investor jurisdictions do not agree with this attribution, creating a mismatch. It does not matter whether a conflict of attribution would arise for all types of income that accrues to the trust, only whether the income in question results in a mismatch. The rule encompasses any type of income received by the trust but requires that the amount is not included in any party's income for tax purposes, in which case there would be no mismatch.

In practice the outcome of the application of Recommendation 4 is illustrated below:

Figure 5: Result of the Application of Recommendation 4



[120] Mechtler L & Wong Sui Ching, C 2016, 'Mismatches in tax outcomes in the light of BEPS Actions 2 and 5', *School of Accountancy Research Paper Series, Special Issue: Tax,* October, vol. 4, no. 3, at p. 29.
[121] *Ibid* 3, at pp. 49 and 55. Refer to Recommendations 10 and 11 for definitions.
[122] Parada argues that the definition of control group actually extends the scope of the rule thereby achieving the opposite of the desired effect and making the rule particularly problematic in cases involving trusts. Since trust-based arbitrage does not necessarily depend on the payer being a participant, it would be unfair to deny the payer a deduction. See *Ibid* 62, at p. 983.

Here, the payer in jurisdiction D remits payment to the trust in jurisdiction E. The income is untaxed in jurisdiction E because, for example, the law attributes the income to a non-resident beneficiary and/or settlor. Although any conflict of attribution will trigger the same result. Recommendation 4 directs jurisdiction D to deny the deduction to the extent of the mismatch (i.e., the amount that escapes taxation in jurisdiction E). The rule is effective regardless of whether the trust, the beneficiary or the settlor is the final recipient of the income. Since the deduction is disallowed in jurisdiction D, the ultimate aim of taxing income at least once is achieved.

Interestingly, recommendation 4 does not contain a defensive response like the other Action 2 recommendations, only a primary response. The justification for this may be that in the case of non-trust reverse hybrid mismatches, controlled foreign company (CFC) legislation should already require that payments to a reverse hybrid entity be included in the income of the investor.[123] Consequently, the reverse hybrid rule only targets the tax treatment of the payment at the source state.

Recommendation 5.1: Settlor Attribution

This recommendation seeks to negate D/NI results by aligning the tax treatment of the payment in the investor jurisdiction with its treatment in the establishment jurisdiction.[124] A D/NI outcome cannot result if the payment is taxed through anti-deferral laws in the investor jurisdictions. The OCED recommends several ways that a jurisdiction can enhance existing legislation: enhancement of CFC rules, residency laws, and rules that tax a resident investor on changes in the market value of an investment.

In the case of a trust, attribution to a beneficiary is not infeasible in respect of accumulated trust income not earmarked for a particular beneficiary of a discretionary trust because taxation of the trust depends on its residence or taxable presence in a jurisdiction willing to tax it; therefore, settlor attribution is of elevated importance.[125] This recommendation appears quite simple to implement: a tightening of settlor

[123] *Ibid* 118, at p. 26.
[124] *Ibid* 3, at p. 62, para 172.
[125] *Ibid* 6, at p. 224.

attribution laws will only affect jurisdictions which either do not already have a settlor attribution regime or distinguish between passive and active income in their existing legislation.[126] Furthermore, such a rule would 'ensure that the payer jurisdiction could suspend the application of the hybrid mismatch rule [Recommendation 4] insofar as payments were allocated to investors in the investor jurisdiction.'[127]

RECOMMENDATION 5.2: TRANSPARENCY LIMITATION

This recommendation solicits the establishment jurisdiction of a reverse hybrid entity to treat the entity as resident with regard to income that is not otherwise taxable in the hands of the investor in the investor jurisdiction if the investor is in the same control group as the entity.[128] Although the recommendation refers to residence, residence is conceived here as implying transparency[129] and the recommendation intends to direct the establishment jurisdiction 'switch of' the transparency of the reverse hybrid entity. In effect, this would put an end to investors taking advantage of an entity's tax residency to achieve mismatch outcomes. There are requirements needed to trigger Recommendation 5.2:[130]

a) the person is tax transparent under the laws of the establishment jurisdiction;
b) the person derives foreign source income or income that is not otherwise subject to taxation in the establishment jurisdiction;
c) all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.

While most Action 2 recommendations are limited by both the structured arrangement and control group concepts, Recommendation 5.2 is subject to only the latter concept.

The chapter 5 recommendations are presented in order of hierarchy, with Recommendation 5.1 being of higher importance to Recommendation 5.2. This seems

[126] *Ibid* 6, at p. 225.
[127] *Ibid* 3, at p. 62, para 173.
[128] *Ibid* 3, at p. 64, para 174.
[129] *Ibid* 6, at p. 226.
[130] *Ibid* 3, at pp. 64-65, para 175.

counterintuitive since trust residence is a more nebulous concept than settlor and beneficiary residence.[131]

RECOMMENDATION 5.3: EXCHANGE OF INFORMATION

Communication and co-operation between jurisdictions are essential to facilitate Recommendations 5.1 and 5.2. Thus, these recommendations are followed by one which encourages jurisdictions to maintain appropriate reporting and filing requirements for entities established within that jurisdiction.[132] The creation and maintenance of records should include details of investors, the value that each investor holds, the amount of income and expenditure attributed to each investor, and the categories of the income and expenditure amounts. These records should be made available to the relevant jurisdictions on request.

RECOMMENDATIONS 3 AND 6: PAYMENTS FROM HYBRID ENTITIES

Recommendations 3 and 6 concerns trust transactions wherein the trust acts as a hybrid entity, in contrast to the aforementioned recommendations in which trusts act as reverse hybrid entities. As mentioned, they have quite limited potential application with regard to trusts. They deal with payments from a hybrid entity, as opposed to the previously discussed recommendations which deal with payments to hybrid entities and affect hybrid entities that are 'radically transparent'[133] owing to settlor attribution. Under such circumstances, the possibility exists for trust losses to be set off in the trust's jurisdiction of establishment against income that is not attributed to the settlor in his jurisdiction. Against this background, the OECD proposes linking rules that will align the tax outcomes for the payer and payee.[134]

Recommendation 3 addresses D/NI outcomes while Recommendation 6 addresses DD outcomes. They contemplate payments such as 'service payments, rents, royalties and interest that may set-off against ordinary income'[135] and apply only to payments made in

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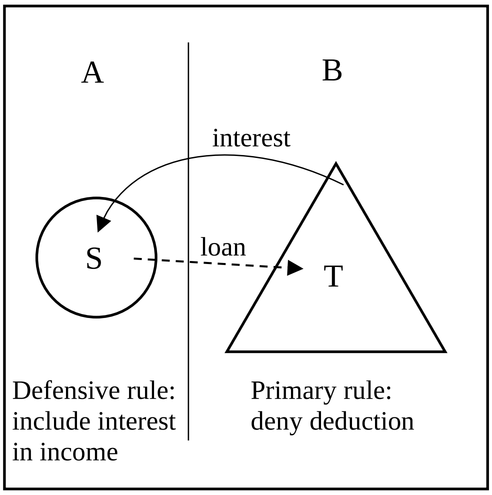
[131] *Ibid* 6, at p. 230.
[132] *Ibid* 3, at p. 65, para. 176.
[133] *Ibid* 6, a p. 237.
[134] *Ibid* 3, at p. 50, para. 119.
[135] *Ibid* 3, at p. 51 para. 121 and p. 70 para. 188.

a structured arrangement or between members of the same control group. Distributions and other types of payments are addressed rather under Recommendations 1 and 2.

Recommendation 3

Recommendation 3 requires the payer (trust) jurisdiction to disallow the deduction to the extent of the mismatch. Failing that, the payee jurisdiction should include the income to the extent of the mismatch. For example, a trust (T) in jurisdiction A pays interest on a loan issued by the settlor (S) in jurisdiction B. If the payment generates a D/NI outcome, the application of Recommendation 3 would necessitate the denial of the deduction in jurisdiction A. If Jurisdiction A does not comply, jurisdiction B will include the interest in the settlor's income.

<u>Figure 6: Application of Recommendation 3</u>



In the corporate context there is wide application for this rule, especially where entities are consolidated for tax purposes. In the context of a trust, it is difficult to replicate. The rule may be applicable to transactions involving US grantor trusts in which the trust is radically transparent and treated almost like a possession of the grantor:[136]

> In general, a U.S. person who is treated as the owner of a foreign trust under the grantor trust rules (IRC sections 671-679) is taxed on the income of that trust. IRC section 679 applies specifically in the context of foreign trusts and will treat as an

[136] *Ibid* 6, at p. 238.

> owner of a foreign trust a U.S. person who transfers assets to a foreign trust which has or is presumed to have a U.S. beneficiary. Each U.S. owner of a foreign trust should receive a Foreign Grantor Trust Owner Statement (Form 3520-A, page 3) from the foreign trust, which includes information about the foreign trust income they must report.[137]

While the scope of application of this recommendation in regard to trusts is narrow, it may see greater relevance as the number of trust redomiciliations to the US has increased greatly in the last few years.[138]

If the beneficiaries of the foreign grantor trust are not tax resident in the US and not required to include a payment in their income, a mismatch subject to Recommendation 3 may result. If the trust is not in profit, deduction may be carried forward to and set off against income which is not attributed to the grantor or beneficiary. Ultimately, the entity may lose its status as a grantor trust upon the death of the grantor, meaning that income can no longer be attributed to the grantor.

Recommendation 6

Recommendation 6 applies to payments to third parties who need not be related, constituting an exception to the control group concept, and payments between the investor and trust which impute income-generating deductions for both parties. Under these circumstances, the trust qualifies as a *hybrid payer*.[139] The Recommendation calls on the jurisdiction of the settlor to deny the deduction, failing which, the establishment jurisdiction of the trust should apply the defensive rule and deny the deduction to the extent of the mismatch.

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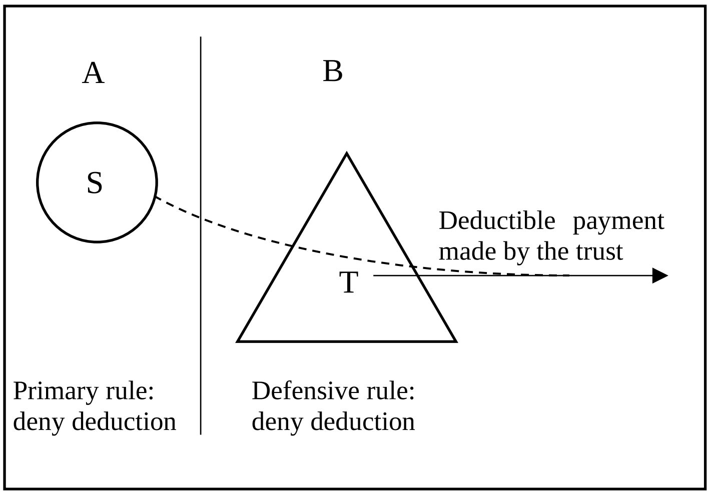
137 IRS, *Foreign Trust Reporting Requirements and Tax Consequences*, viewed 8 March 2011, <irs.gov/businesses/international-businesses/foreign-trust-reporting-requirements-and-tax-consequences> Available at: irs.gov/businesses/international-businesses/foreign-trust-reporting-requirements-and-tax-consequences [Accessed 8 March 2021], at para. 10.
138 Cooper, O and Reymond, R 2021, *STEP Bermuda Webinar Series: European Union (EU) Blacklist.*
139 *Ibid* 3, see Recommendation 6.2.

Figure 7: Application of Recommendation 6.2



SUMMARY OF ACTION 2 RECOMMENDATIONS RELATING TO TRUSTS

As summarised in Table 3 below, the Action 2 recommendations address trust mismatches resulting from conflicts of attribution. Under such circumstances, trusts mainly act as reverse hybrid entities; however, there are limited scenarios in which the trust acts as a hybrid payer. The former is addressed by Recommendations 4 and 5, and the latter by Recommendations 3 and 6.

Table 3: Summary of Action 2 Recommendations Relating to Trusts

<table>
<tr><th rowspan="2">Conflict Type</th><th rowspan="2">Contributing Trust Attribute</th><th rowspan="2">Arrangement</th><th rowspan="2">Resulting Mismatch</th><th rowspan="2">Specific Recommendations</th><th colspan="2">Hybrid Mismatch Rule</th><th rowspan="2">Recommendation Number</th></tr>
<tr><th>Primary Response</th><th>Defensive Response</th></tr>
<tr><td rowspan="6">Conflict of attribution</td><td rowspan="5">Settlor attribution

Differential transparency

Item allocation

Entity classification</td><td rowspan="3">Payment made to reverse hybrid entity</td><td rowspan="3">D/NI</td><td>Improve settlor attribution regime</td><td></td><td></td><td>5.1</td></tr>
<tr><td>Restrict tax transparency of the reverse hybrid entity in the establishment jurisdiction</td><td></td><td></td><td>5.2</td></tr>
<tr><td></td><td>Deny payer deduction</td><td>N/A</td><td>4</td></tr>
<tr><td rowspan="2">Payment made by hybrid entity</td><td>D/NI</td><td></td><td>Deny deduction in trust’s jurisdiction</td><td>Include in income of the settlor</td><td>3</td></tr>
<tr><td>DD</td><td></td><td>Deny deduction in settlor’s jurisdiction</td><td>Deny deduction in trust’s jurisdiction</td><td>6</td></tr>
<tr><td>Internal coherence</td><td></td><td>May lead to under or over taxation but no mismatch</td><td></td><td></td><td></td><td>N/A</td></tr>
<tr><td>Conflict of residence</td><td>Trust residence</td><td></td><td>May create indefinite deferral but no mismatch</td><td></td><td></td><td></td><td>N/A</td></tr>
<tr><td>Conflict of distribution to beneficiaries</td><td>Distribution taxation</td><td></td><td>May affect tax liability in the beneficiary’s jurisdiction but no mismatch</td><td></td><td></td><td></td><td>N/A</td></tr>
</table>

CHAPTER 5: EVALUTION OF THE RECOMMENDATIONS

Through its work on the BEPS project, the OECD has highlighted the failings of the bilateral paradigm: even countries with developed economies are enthusiastically involved in the process since they cannot currently enforce their tax laws as desired. The OECD articulated a vision for the BEPS project that:

> a) mitigates corrosive tax competition between governments in favour of greater tax co-operation and co-ordination;
> b) fosters a coherent approach to cross-border income taxation that authorizes a jurisdiction to deny tax relief where necessary to protect its tax base (as well as to yield tax base to avoid double taxation); and
> c) reduces cross-border information asymmetry between taxpayers and governments through measures to enhance transparency[140]

However, they did not succeed in enforcing this message through its Action Plan. Brauner suggests that the Plan is lacking the key elements of legitimacy and stability of the international regime.[141] One contributing factor may be the haste with which the OECD tackled the project, triggering patchwork measures based on existing mechanisms instead of the comprehensive change originally promised.

A STEP TOWARDS THE SINGLE TAXATION AND THE BENEFIT PRINCIPLE?

As discussed, the single tax principle expresses the need to tax income once thereby preventing both double taxation and non-taxation. Avi-Yonah commends the OECD's work as a step towards single taxation: 'It demonstrates significant political commitment to by the G20 and OECD to the single tax principle.'[142] Similarly, De Lillo considers the BEPS project to be inspired by the single tax principle.[143] It is clear that there is some connection to the single tax principle in the BEPS Action Plan framework: There is an effort to ensure that income in a mismatch arrangement does not escape taxation

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[140] Christians, A & Shay, S 2017, 'Assessing BEPS: origins, standards, and responses', *International Fiscal Association*, vol. 102, at p. 23.
[141] *Ibid* 14, at p. 60.
[142] *Ibid* 28, at p. 16.
[143] *Ibid* 27, at p. 35.

altogether by disallowing payer deductions or ensuring the inclusion of a payment in the income of the receiver. However, others argue that this is not sufficient evidence to affirm that the single tax principle is the purpose of the BEPS Action Plan, and single taxation is certainly not achieved.[144]

The goal to tax income once and only once is not addressed in the Action Plan. The only concern is that income should not escape taxation altogether. In order to achieve single taxation, the system of international tax rules and division of current cross-border income taxation would need to be reconsidered entirely. Lamentably the OECD has only tackled specific symptoms of mismatch arrangements by patching up existing tax rules and without considering the broader picture. The complex web of rules directly contradicts the central theme of the single tax principle which is simplicity.[145] Such an approach cannot be expected to achieve the lofty goal of single taxation.

Furthermore, the single tax principle is inherently linked to the benefit principle which requires that income is taxed in the place where the value is created. Avi-Yonah and Xu put forward that the OECD Plan reflects the single taxation principle and the benefits principle,[146] but it is difficult to understand how this conclusion was reached. While the G20[147] and the OECD[148] laid out the realignment of taxation with value creation as a clear objective for the BEPS project from the time of its inception and reaffirmed it throughout the planning process,[149] the goal has not been realised. The Plan does not indicate where an entity is regarded as having its economic activity and no test is set out to establish what

[144] Gil Garcìa, E 2019, 'The single tax principle: fiction or reality in a non-comprehensive international tax regime?', *World Tax Journal*, vol. 11, no. 3, at p. 339.
[145] Parada L, 2018a. *Dounble non-taxation and the use of hybrid entities.* Alphen ann den Rjin: Kluwer Law International, at p. 5.
[146] *Ibid* 24, at p. 101.
[147] The G20 notes that 'profits [should be] taxed where economic activities occur and value is created.' See *Ibid* 98, at p. 4.
[148] *Ibid* 1
[149] In the Action 2 Final Report , the OECD specifies: 'The Action Plan aims to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.' See *Ibid* 3, at p. 3. Also see OECD 2014e. *Two-part report to G20 Developing Working Group on the impact of BEPS in low income countries: Part 1 (July 2014), Part 2 (August 2014)*; OECD 2014f, *Discussion Draft, BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws*); and OECD 2020, *OECD/G20 inclusive framework on BEPS, Progress report July 2019 - July 2020.*.

the indicators of economic activity may be.[150] It is completely silent as to which state should collect the tax revenue. The very nature of the linking rules contradicts this objective: there seems to be no logical connection between the rules and value creation. The primary rules require that the payer deduction is denied while the defensive rules require that the payment is included in the receiver's income. The place of value creation is not even briefly contemplated, and the application of the rules is in no way contingent on this factor.

In effect, the solution proposed by the OECD may strip the right to tax from the jurisdiction of value creation to a degree that cannot be overlooked. This creates a serious concern for developing countries, most of which have not had a significant voice in the design phase of the Action Plan. Very few developing countries are members of the G20, and the short timeframe set by the OECD ensured that the concerns of these countries could not be realistically addressed in a later phase. The result reinforces the notion that the OECD considers itself more of a club for rich countries than a leader in international development.[151]

CONSEQUENTIALIST APPROACH

Parada clarifies that while the OECD's proposed target is the hybrid entity itself, the existence of a hybrid or reverse hybrid entity is not sufficient to initiate the linking rules set out. It is required that a payment generates a D/NI or DD outcome.[152] The core of the problem (i.e., a disparity in the tax characterisation of entities) is not addressed and the focus of the OECD lies on the outcome of the transaction and not on the hybrid element: a *consequentialist approach* has been adopted. In order to target the core issue, coordination would be necessary, as will be discussed further in Chapter 7; however, this approach seems utopian in nature and just as unachievable as the consequentialist approach.

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[150] Cerioni, L 2016, 'The quest for a new corporate taxation model and for an effective fight against international tax avoidance within the EU', *Intertax*, vol. 44, no. 6, at p. 473.
[151] *Ibid* 18.
[152] *Ibid* 69, at p. 976.

It would appear that the current perspective on hybrid entities is misinformed. A D/NI or DD outcome is not adequate evidence of hybrid entity misuse.[153] This effectively turns the understanding of the concept of tax avoidance aggressive, which is 'traditionally linked to the absence of economic substance or artificiality of a cross-border transaction, into the focus of eliminating double non-taxation.'[154] The consequentialist approach disregards other complexities involved, such as legality and the methods used within a transaction that contribute to the double non-taxation outcome, and furthers the stigmatization of the double non-taxation outcome. Parada is of the opinion that double non-taxation is not an undesirable outcome and not inherently interconnected to the hybrid and reverse hybrid entities. The double non-taxation outcome is thus not the undesirable element, but the disparity of hybrid entity characteristics is.[155] He contends that the *intention* of the states is irrelevant and cannot constitute a counterargument because: 'To assume that the 'intention of the States' can be obtained purely without considering the influence of political malfunctions simply implies not to understand the reality in the lawmaking process.' Indeed, it is naïve to assume the states' intention since a gap may be aimed at promoting investment. The intention could only be known if explicitly stated.

The approach adopted by the OECD therefore forces the concept that double non-taxation is a negative result specifically achieved through cross-border trade. It ignores the possible legal validity of the transactions. The OECD's broad and imprecise attempt to solve the problem through vague recommendations will result in the targeting of other legal structures involving hybrids that are not necessarily a function of aggressive tax planning. Disparities in domestic law and entity characterisations are indeed the norm and a mismatch is not necessarily an indication of aggressive tax planning. In some cases, a disparity in law will not give rise to an inconsistent outcome. The approach misdirects the target of the Plan from the hybrid element to the outcome of the transaction, contradicting the OECD's stated objectives.

[153] *Ibid* 69, at p. 993.
[154] *Ibid* 145, at p. 68.
[155] *Ibid* 145, at p. 68-69.

Dependence on Foreign Domestic Law

The application of the rules proposed by the OECD is highly dependent on foreign domestic laws. While there is an abundance of tax laws, such as CFC rules, which consider foreign laws and depend on them to a certain degree, the Action 2 rules differ in that they are completely dependent on foreign law. While CFC rules necessitate an understanding of foreign law, the Action 2 rules require a detailed and expansive knowledge of foreign law. 'The former [CFC rule] seems easier for taxpayers and tax administrations as it requires less technical understanding about foreign tax rules and less factual knowledge about the fact and circumstances.'[156] It is a substantial leap from calculating a foreign tax credit to being structurally dependent on another country.

As will be discussed below, there is no decent policy reason for a country to deny a deduction because another state classifies the receiver of the payment differently and one cannot expect states to act against their own interests. It is therefore highly unlikely that states will implement the rules.

The dependency on foreign law raises concerns with some basic taxation principles: the principle of equality and the sovereignty of states. In regard to the former, if a state follows the classification of an entity of a foreign country, disregarding the structural comparability to domestic entities or the domestic classification of the entity, the principle of equality is contravened.[157] 'Cooper notes that 'it does seem more than a little odd to say that states should agree to a rule for no reason other than this imposes tax on someone somewhere'.[158] Why should a taxpayer be penalised with the denial of a deduction simply because the transaction in question is cross-border in nature? In regard to the latter, the legislator would effectively limit its sovereignty by disregarding its own classification of an entity and depending on foreign law. Implementation of the Plan is thus unlikely as

[156] Lüdicke, J 2014, '"Tax arbitrage" with hybrid entities: challenges and responses', *Bulletin for International Taxation*, vol. 68, no. 6/7, at p. 313.
[157] *Id* at 309.
[158] *Ibid 159*, at p. 345.

‘Surrendering sovereignty over tax matters to other states is not something governments are used to or are likely to enjoy’.[159]

THE PRISONER’S DILEMMA

BEPS is an international issue and thus necessitates an international solution centring on co-operation and inclusiveness. The Action Plan, however, is based on domestic fixes. The OECD also failed to include most developing countries in the planning stages, meaning that their unique concerns are not addressed in the Plan. The proposals of the developing countries that were consulted were not necessarily adopted by the OECD.[160] As a result, the chances that all countries will implement the Action 2 rules is greatly diminished. Without assurance that other countries will implement the Action 2 rules, it is unlikely that there will be broad adoption. ‘The focus should be on a body in which countries can have some degree of assurance that, where they are accepting certain restrictions on their tax sovereignty, other countries will be taking the same steps.’[161] Legislators will be cautious to adopt the rules and risk damaging their state’s attractiveness as an investment jurisdiction. This is the ‘classic prisoner’s dilemma or assurance game situation.[162]

If states are slow in the convergence process, the entire process will be delayed. Worse yet, states may engage in a race to the bottom.[163] If one or more jurisdictions do not implement Action 2, it seems inevitable that entities will redomicile and continue trade in jurisdictions which allow for hybrid mismatch arrangements.[164] Tax competition between countries will continue and Action 2 has done little to further co-operation. As will be discussed in Chapter 6, this can be alleviated by the establishment of minimum

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[159] Cooper, GS 2015, ‘Some thoughts on the OECD's recommendations on hybrid mismatches’, *Bulletin for International Taxation,* vol. 69, no. 6/7, at p. 346.
[160] *Ibid* 24, at p. 211.
[161] Ault, H J 2001, ‘The importance of international co-operation in foreign tax policy’, *Brookings Journal of International Law,* vol. 26, at p. 1696.
[162] *Id*
[163] *Ibid* 24, at p. 215
[164] Wilming, L 2018. ‘Tax autonomy and hybrid mismatch arrangements: challenges to tax autonomy in an era of conflicting political goals’, Tilburg: Tilburg University., at p. 77.

standards or a memorandum of understanding between states[165] since Action 2 only comprises soft recommendations.

Compliance Costs and Diminution of Cross-Border Trade

Countries will require significant expertise to successfully carry out the drafting of legislation and implementation of the law. The Recommendations can only be successfully applied if legislation is well-drafted with narrow language that does not leave room for different interpretations; however, this is a substantial challenge that will translate to heavy compliance costs. Legislators will also need to account for remedies for taxpayers if other states are non-compliant or implement the Recommendations poorly.[166] Failure to do this may negatively impact the jurisdiction's attractiveness as an investment destination.

Furthermore, even if all countries successfully implement the Recommendations, new opportunities for BEPS may arise due to the arbitrariness which are not provided for in the Recommendations.[167] The OECD has only addressed technicalities instead but in order to counteract the wide range of opportunities to abuse hybrid mismatches it is necessary to focus on international coordination. Since not every country can be a winner, this is a highly challenging prospect. Instead, the OECD has relied strongly on exchange of information which 'advocates ad hoc solutions to the most visible symptoms rather than a holistic solution, as is required by the second principle of BEPS, and it completely lacks innovation or even consideration of a new approach to the issue'.[168]

From a taxpayer perspective, the amount of compliance costs and administrative responsibilities will greatly increase. Particularly in the corporate environment, this may serve as a disincentive for cross-border trade[169] and would directly contradict the efforts

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[165] *Ibid* 24, at p. 215. See also *Ibid* 161.
[166] Venetikoski, L 2017, 'EU approach to elimination of hybrid mismatch arrangements: Analysis under the objectives of Anti-Tax Avoidance Policy', Tilburg: Tilburg University., at p. 30.
[167] *Ibid* 24, at p. 208.
[168] *Ibid* 18, at p. 84.
[169] *Ibid 166*, at p. 30.

of the international tax community over the last century to implement DTAs that encourage co-operation between jurisdictions and the free movement of capital.

Given that developing countries had limited input into the planning, their unique needs have not been adequately addressed. The process of public debate was overall insufficient as the representatives of developed countries vastly outnumbered those of developing countries. The OECD received more the 12,000 pages of comments on the proposed Recommendations, but it is unknown to what extent these comments were incorporated.[170] Developing nations may be further impacted by their limited experience in legislative drafting and implementation and the lack of resources available to them to enforce the BEPS Actions. Yet the Action Plan comes very short of dealing with the difficulties of implementation.[171] The particular struggles of developing countries will be discussed in depth in Chapter 7.

CIRCULAR EFFECT OF THE RULES

The most concerning deficiency of the Action 2 proposal is that the linking rules give rise to *circular effect*.[172] When the tax laws of both countries refes to the tax treatment in the other country, there might never be a logical conclusion. This may drive the absurd result that the countries both remain undecided. If both the primary rule and the defensive rule are applied by the two jurisdictions involved, the result will be double taxation which is arguably more undesirable than double non-taxation. The Action Plan demonstrates a profound preference for double taxation over double non-taxation. The OECD attempts to offset this issue with a hierarchy of rules: the defensive rule, being subordinate, should only be implemented if the country of the payer fails to implement the primary rule. This hierarchy was not included in the initial literature and does represent an effort on the part of the OECD to incorporate the feedback received. None the less, there is a substantial likelihood that countries will fail to coordinate their responses given the complex nature of the recommendations, and the potential disparity of implementation between countries.

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[170] *Ibid* 24, at p. 211.
[171] *Ibid* 18, at p. 84.
[172] Dziurdź, K 2013, '"Circularly linked" rules countering deduction and non-inclusion schemes: some thoughts on a tie-breaker test', *Bulletin for International Taxation,* vol. 67, no. 6, at p. 307.

The issue is further complicated by group consolidations and delayed timing of transaction inclusions.

If countries interpret the OECD Recommendations with significant disparity, Dziurdź recommends that the resulting circular link may be removed through the inclusion of a tie-breaker test within the domestic law, much like those included in DTAs. He suggests that a tie breaker may be drafted in any of the following ways:[173]

1. by applying a rule countering deduction and non-inclusion schemes only if the other country does not provide for a corresponding rule;
2. by disregarding, for purposes of the rule countering deduction and non-inclusion schemes, all of the provisions of the other country that contain a "back link ...; or
3. by adopting an international meaning of equity and debt [or entity classification] and, in this way, thereby coordinating the rules of the countries countering deduction and non-inclusion schemes.

The design of the above rules is certainly not an easy task, and the OECD provides no guidance on the matter. While the hierarchy of the primary and defensive rules does apply to the application of the rules, it does not negate the circular nature itself since the treatment in one country is still dependent on the treatment in another country. Effectively, 'the circularity issue is simply moved from the rule counteracting the hybrid mismatch to the tie-breaker rule'.[174] Parada disputes that the tie-breaker solution is far too complex, and the OECD system should be replaced entirely,[175] as will be discussed in Chapter 7.

This associated problem of potential double taxation becomes particularly glaring when Recommendation 4 is considered. As mentioned, there is no defensive rule included in this Recommendation since existing CFC and settlor attribution rules replace the need for a defensive rule. As a result, double taxation may occur more often when

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[173] *Id*
[174] *Ibid* 145, at p. 534.
[175] Parada, , L 2019, 'Hybrid entity mismatches: Exploring three alternatives for coordination, *Intertax,* 1 January, vol. 47, no. 1.

Recommendation 4 is applied, since the payee jurisdiction does not have the choice whether to apply the defensive rule or not.

ACCOUNTING FOR THE DISTINCTIVE ATTRIBUTES OF TRUSTS

It is clear that the OECD has not accounted for the distinctive attributes of trusts which contribute to trust-based hybrid mismatches. The Recommendations do not deal with the trust in a logical or systematic way.[176] It appears that Action 2 was conceptualised around the corporation and does not address the distinctive attributes of trusts or the transparent taxing paradigms under which many jurisdictions tax trust income. The trust instrument has great capacity to generate controlled outcome and is often employed to do so. As such, it is surprising that Action 2 does not consider the trust more closely.

The Establishment Jurisdiction

The language of the Recommendations appears to assume that a hybrid or reverse hybrid entity has exactly one establishment jurisdiction. As discussed, the topic of trust establishment jurisdictions is an intricate one. Thus, it is difficult to see how Action 2 can successfully contain the abuse of trust-based hybrid mismatches if the Recommendations hinge on a manipulable element.[177] Although the Recommendation refers to residence, it is primarily concerned with taxability.

Additionally, there is a risk of double taxation of a trust if Recommendation 5.2 is applied and the fiscal transparency of the entity is switched off in the payee jurisdiction. This is a risk to which a trust is already subject if it is a dual resident and may be alleviated through a DTA.

Recognition of the Settlor as an Investor

It is certain that a beneficiary of a trust who receives a distribution is considered to be an investor; however, the qualification of the settlor remains unclear. There are many details

[176] *Ibid* 6, at p. 241.
[177] *Ibid* 6, at p. 222.

specific to each individual trust that contribute to determination whether the settlor should be included as an investor:

> The grantor may (or may not) be the attributed owner of the trust or trust income; may have (or may lack) reversionary rights; may benefit indirectly from the enrichment of his or her family members or legal dependents; may be able to control or influence the distribution policy of the trust, its terms or its trustees; and so on.[178]

Action 2 does not address how legislators should approach such intricate trust particulars which may have vast implication for the implementation of the Recommendations. Furthermore, if both a beneficiary and settlor associated with a particular transaction can qualify as the investor, double taxation once again becomes a risk.

[178] *Ibid* 6, at p. 224.

CHAPTER 6: ADOPTION OF THE OECD RECOMMENDATIONS

INTERNATIONAL ADOPTION

Governments have begun implementing the BEPS initiatives to a varying degree with many jurisdictions adopting a wait-and-see stance. There are several factors contributing to a slow uptake of the Action 2 Recommendations in particular. The Actions items vary from 'binding' minimum standards (Actions 5, 6, 13, and 14), to soft recommendations (Actions 2, 7, 8, 9, and 10), best practices (Actions 12 and 14), and items requiring further discussion. As such, Action 2 – a soft recommendation – has seen limited realisation. Legislators are wary to forging a path and hoping that other countries will follow suit carries the substantial risk that others will not follow or that convergence will be slow. This would negatively impact the attractiveness of the jurisdiction as an investment jurisdiction. This conflict is clearly expressed in a report on the UK working group branch by the International Fiscal Association (IFA):

> The potential tension between the UK's support of the OECD BEPS project and domestic measures designed to attract domestic investment may become particularly pronounced in the light of any steps taken to implement a 'Brexit' from the EU, as the UK will be especially keen to maintain its status as a leading international financial centre and business hub.[179]

The report continues:

> It is worth noting that the UK government is cognizant of the need to attract inward investment, especially following the outcome of the 'Brexit' referendum, and it will therefore be interesting to see whether the UK government is willing to take any measures (either the introduction of new rules or amendments to existing rules) that are not compliant with the OECD's anti-BEPS recommendations.[180]

The conflicting desires of legislatures to further their countries' own interests while curbing BEPS practices through the OECD Recommendations are further complicated by

[179] See UK report Summary, as cited in Christians and Shay *ibid* 140.
[180] See UK report at section 1.3.2., as cited in Christians and Shay *ibid* 140.

the scope of the plan. The Recommendations cover intersecting areas of tax law, highly complex concepts, and politically sensitive topics. The prisoner's dilemma is nurtured by countries' hesitancy to reveal their motivations and goals.[181] Additionally the degree of influence of private lobbyists on the final Recommendations is unknown on the final, which lends further obscurity to a project with the intended theme of transparency. Thus, it is not surprising that enactment has not been a unified effort.

Given that the Recommendations consist of a patchwork attempt to rectify gaps in existing legislation, legislators must begin by examining whether their national laws meet the OECD Recommendations. Many believe that they are already largely compliant with the Action Plan and no changes are necessary.[182] For instance, Australia's Board of Taxation recommended against the implementation of Recommendation 5.1 on the basis that the country's existing rules are sufficient and there are no integrity concerns. In the trust context, there is very little indication internationally whether countries that do not have outbound settlor attribution rules will enact changes.

It can be expected that implementation of the rules will not be uniform since countries already have different CFC and settlor attribution rules. To maintain states' sovereignty, changes to domestic law are left to the choice of states which will deliberate concerning complex factors including their divergent legal traditions. Some jurisdictions may continue to treat hybrid and reverse hybrid entities as fiscally transparent conduits, while others may continue to treat them as separate taxable entities. The process of convergence may therefore be very slow, and countries may argue that the direction they adopt is consistent with the direction of the BEPS Plan despite their departure from the direction of other jurisdictions. Worse yet, some countries may resort to a race to the bottom, thereby negating any positive movement in other jurisdictions.[183]

The OECD failed to address how inconsistencies in the implementation of the Recommendations should be addressed which again underscores that the intended theme of international co-operation and co-ordination was not achieved in the Action Plan.

[181] *Ibid* 140, at p. 24.
[182] Board of Taxation (Australia), 2016. Implementation of the OECD hybrid mismatch rules, p. 44.
[183] *Ibid* 24, at p. 215.

Moreover, EU members will be forced to implement the binding mandates of the European Commission (EC) through ATAP which differs from, and at times contradicts, the OECD Recommendations, as will be explored in Chapter 7. A clear solution to this problem is for the OECD to establish minimum standards for the implementation of Action 2.[184]

ADOPTION IN THE DEVELOPING WORLD

The developing world battles different tax compliance problems to the members of the OECD, and as a result questions of how or whether to adopt the Recommendations are more complex. It is clear that adjustments to strengthen countries' ability to collect taxes must be enacted because corporate tax is a very important source of revenue for most African countries – with an average of 29 percent of total revenue. [185] The loss of tax revenue in African countries leads to critical underfunding of investment infrastructure that could fund economic growth and further discourages tax compliance by fostering the notion that the tax system is unfair. In order to promote long-term sustainable development in Africa it is essential that the international tax system prevails over modern challenges.

It is acknowledged that developing countries are not homogenous and their capacity to implement BEPS initiatives vary widely as a result of their limited experience in the administration of complex tax matters.[186] Historically, African countries have focused on domestic tax issues, prioritising the taxation of domestic income of resident taxpayers.[187] Most do not have highly developed tax laws to counter BEPS and have depended on strong exchange control regimes to discourage residents from foreign investment and prioritised the taxation of domestic income of residents. Most African countries do not have a wide network of DTAs owing to their inward focus and the belief that agreements

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[184] *Ibid* 24, at p. 215.
[185] Oguttu, AW, 2016, 'Tax base erosion and profit shifting in Africa - part 1: Africa's response to the OECD BEPS action plan', Brighton: *Institute of Development Studies*, at p. 11.
[186] G20 2014, *G20 response to 2014 reports on Base Erosion and Profit Shifting and Automatic Exchange of Information for developing countries. Development Working Group on Domestic Resource Mobilisation* <http://www.g20.utoronto.ca/2014/16%20G20%20response%20to%202014%20reports%20on%20BEPS%20and%20AEOI%20for%20developing%20economies.pdf> at p. 3.
[187] Thuronyi, V 1998, *Tax Law Design and Drafting*, International Monetary Fund.

would result in a loss of taxing rights. With the increased international focus on BEPS, African countries are turning this attention to international co-operation. Africa can no longer isolate their tax systems will need to cultivate attractive environments for foreign investment, but their tax laws are not well-developed to counteract BEPS that arises through the abuse of tax treaties.

Many developing nations do not have the administrative capacity to implement the OECD Recommendations. The Recommendations present a challenge even for the most developed jurisdictions owing to the level of knowledge of foreign tax law required. In order to administer complex international laws, African countries would need to employ competent officials in various fields (such as accounting, law and economics), provide continuous training to keep up with international developments, and ensure that their officials are paid salaries comparative to those in the private sector. Additionally, measures should be taken to ensure integrity amongst tax officials, which is currently a challenge in many African countries. Ultimately, African countries will need to evaluate the effectiveness of their current legislation by establishing a tax committee or forum to undertake the review, and then determine what support it requires to address any uncovered issues. Organisations such as Tax Inspectors Without Borders of the OECD and the United Nations Development Programme can assist the effort and provide funding.[188]

In a 2014 Report to the G20,[189] the OECD acknowledged that developing countries have specific needs that were not yet addressed:

a) The nature of cross-border tax planning may differ between developing and developed countries;
b) Developing countries may lack the necessary legislative measures needed to address BEPS;
c) Accessing relevant information is often difficult;

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[188] United Nations Economic Commission for Africa 2018, *Base erosion and profit shifting in Africa: reforms to facilitate improved taxation of multinational enterprises,* Addis Ababa: Economic Commission for Africa, at p. 13.
[189] OECD 2014e, *Two-part report to G20 Developing Working Group on the impact of BEPS in low income countries: Part 1 (July 2014), Part 2 (August 2014),* at pp. 16-18.

d) Building and maintaining capacity to implement highly complex international rules leave room for discretion in their application;
e) Need for political impetus and support for effective measures to counter BEPS highlighted in regional consultations;
f) The acute pressures on developing countries to attract investment can trigger a competitive 'race to the bottom'.

The recognition of developing world challenges paved the way for legitimate debate that had the potential to enhance the robustness of the OECD Action Plan. For the purposes of the multilateral instrument detailed in Action 15, the OECD invited hundreds of countries to participate in an Ad Hoc Group[190] with the intention of placing OECD non-member states 'on equal footing' as member states. Discussion centred mainly around Actions 2, 6, 7, and 14. In 2016, the OECD launched an inclusive framework which allows interested countries and jurisdictions to work with OECD and G20 members on developing standards on BEPS related issues, and to review and monitor the implementation of the whole BEPS package.[191]

Despite this, the findings of the discussions saw very limited fulfilment in the Final Report[192] and did little to legitimise the role of the OECD in setting international standards for developing countries.[193] The short timeframe set by the OECD ensured that the input from developing countries could not be addressed. The Action Plan is built on rules that have historically favoured the first world and lacks an understanding of the particular needs of developing countries. The promise of ingenious international tax reform was not fulfilled as the allocation of taxing rights between the source and residence countries constituted a pivotal element of change. This failure reinforces a system that exacerbates inequality. Some international tax issues, such as withholding taxes, that are highly relevant to African countries are not addressed in the Action Plan. Since taxpayers have found ways to manipulate the existing system, there is little reason to expect that the

[190] OECD 2015b, *Explanatory statement to the multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting*, <https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>
[191] OECD 2016, *Inclusive framework for BEPS implementation*, <https://www.oecd.org/tax/background-brief-inclusive-framework-for-beps-implementation.pdf>, at p. 11.
[192] *Ibid* 188, at p. vi.
[193] Burgers, , I & Mosquera, I 2017, 'Corporate taxation and BEPS: a fair slice for developing countries?', *Erasmus Law Review*, 28 August, vol. 10, no. 1, at p. 31.

patchwork reforms would prevent further abuse. The damaging effects of BEPS will continue to be felt by developing and first-world countries alike.

None the less, while the trend of BEPS focus by the international community continues, there is an opportunity for African countries to raise their long-standing BEPS concerns with greater assurance that the international community will support their goals. Although BEPS is a global concern, certain aspects of the problem that affect first-world countries do not hold true in the African paradigm. Providing input from their unique perspectives will allow African countries to correct the impression that they are 'instruction-takers not decision-makers'[194] in the global community. The African Tax Administration Forum (ATAF) which promotes co-operation between African tax administrators is an ideal setting for African countries to develop a united position on BEPS concerns to be presented to the OECD. ATAF stresses that co-operation and coordination is the solution to solving the distinct BEPS related needs of African countries:[195]

> In developing countries, beyond its fiscal role, the tax system has a more substantive role: it is an important tool for good governance and the basis for the social fiscal contract between governments and its citizens and corporations. Tax revenues are vital to finance their development agenda and the redistribution of incomes, thus contributing to poverty alleviation. In a context where the recent global financial crisis has reduced the importance of official development assistance (ODA) as a reliable source for financing post-2015 Millennium Development Goals (MDGs), developing countries are beginning to realise that the achievement of the MDGs and economic goals (i.e., market reforms, promotion of private sector investment, industrialisation and promotion of regional programmes and development, etc.) will depend heavily on domestic tax revenues. Consequently, creating robust and equitable domestic tax policies and implementing a fair and effective international tax system through international co-operation become primordial.

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[194] *Ibid* 185, at p. 22.
[195] ATAF 2014a, *ATAF Consultative Conference on New Rules of the Global Tax Agenda: An ATAF discussion paper, Johannesburg, South Africa, 18-19 March 2014*, at p. 1.

Implementation in South Africa

South Africa is a member of the G20 and holds OECD Observer status. The country expressed support of the BEPS initiative through signing the OECD Declaration[196] and the G20 Declaration which specifically identified the 15 Action Items laid out by the OECD:[197]

> We look forward to regular reporting on the development of proposals and recommendations to tackle the 15 issues identified in the Action Plan and commit to take the necessary individual and collective action with the paradigm of sovereignty taken into consideration

The declaration is of course that of the G20 and not the Government; None the less, it does politically commit the Government by virtue of its G20 membership.[198]

It is difficult to assess the impact of hybrid-based arbitrage on revenue collection owing to a lack of data collection in the country. None the less, South Africa has spearheaded the effort to enact anti-hybrid abuse measures in the developing world. The country's willingness to pilot the initiatives may be attributed to its G20 membership and large network of treaties which facilitate exchange of information, as well as a stronger engagement with the topic by legal commentators.[199] The Davis Tax Committee acknowledged that South Africa's involvement with the development of the Final Report had been extensive: 'The OECD notes that developing countries and other non-OECD/non-G20 economies have been extensively consulted through regional and global fora meetings and their input has been fed into the work'.[200]

The term *base erosion* beings to appear in the budget documents and in the budget speeches of the Minister of Finance from 2013.[201] South Africa implemented a number

[196] OECD 2013b, *Declaration on base erosion and profit shifting*.
[197] *Ibid* 98, at p. 4.
[198] McCann, P 2015, 'The relevance of the OECD BEPS Action Plan 2 Recommendations for selected aspects of cross border arbitrage through selected hybrid instruments and entity arrangements in South African Income Tax law', Cape Town: University of Cape Town, at p. 14..
[199] *Ibid* 100, at pp. 7-8.
[200] Davis Tax Committee 2017b, *Second interim repot on base erosion and profit shifting (BEPS) in South Africa: Introductory Report,* at p. 22.
[201] National Treasury 2013, *Budget Speech: Minister of Finance, Pravin Gordhan. 27 February 2013*.

of Action Plan related rules within its domestic law, including those relating to hybrid mismatch arrangements, controlled foreign company rules, limitation of interest deductions, addressing harmful tax practices, and transfer pricing. Some were introduced in response to the Action Plan. The majority of the relevant legislation was implemented prior to the Final Report. South Africa implemented the first legislation to deal with the taxation of hybrid entities in 2010 as part of the 2010 Taxation Laws Amendment Act 7 of 2010. South Africa's reaction has differed significantly from other developing nations.

The Davis Tax Committee acknowledged in its first interim report on the Hybrid Report that with regard to hybrid mismatch arrangements the country 'had been proactive and was ahead of the curve'.[202] As a consequence of South Africa's early implementation of anti-hybrid abuse rules, these provisions need to be updated and refined to ensure the country is in line with the international community.[203] The Committee acknowledged the need to review legislation related to hybrid entities:[204]

> South Africa's legislation on hybrid entities is still behind the G20 and there is need for further reform of the provisions to ensure that any tax planning schemes that entail hybrid entities as a mechanism for double non-taxation (as well as potentially giving rise to double taxation) are curtailed. Thus, will require:
>
> – Further refinement of domestic rules related to treatment of hybrid entities;
> – There is need for specific double tax treaty anti-avoidance clauses.

The Committee recommended that the OECD recommendations be adopted with regard to hybrid entity mismatches, but more attention was devoted to remedying of hybrid instrument mismatches.

In the 2015 National Budget Review, the then Minister of Finance Nhlanhla Nene reinstated CFC rules on account of the BEPS:[205] 'It is proposed that diversionary rules

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[202] Davis Tax Committee 2014, *First interim report action 2: neutralise the effects of hybrid mismatch arrangements*, at p. 66.
[203] West C 2016, 'Status Quo of international tax reform in South Africa: Implementation of BEPS and CRS and the influence on domestic law amendment', at p. 2.
[204] *Ibid* 202, at p. 30.
[205] National Treasury of the Republic of South Africa 2015, *Budget Review 2015*, at p. 146.

applicable to the sale of goods by a CFC to a connected resident be reinstated. In addition, consideration will be given to allowing CFCs held by interposed trusts to be subject to tax in South Africa.' The main focus has been on the risk of hybrid mismatch arrangements where they are employed by corporate entities. For example, South Africa recently renegotiated the tie-breaker clause for corporate entities in the Mauritian treaty.[206] In 2016, regulations were issued to facilitate exchange of information along the lines of the CRS regulations and replicating the OECD standards.[207]

Most applicable to trust-based hybrid arbitrage, settlor attribution rules were introduced in 2019 under section 7C of the ITA. Section 7C is an anti-avoidance measure that targets loans made to trusts by related parties which are interest-free or attract an interest rate lower than the official interest rate as defined in paragraph 1 of the Seventh Schedule to the Act. The difference between the interest charged on the loan and the official interest rate is deemed a donation to the trust and is subject to donations tax. The settlor attribution rules detailed in Recommendation 5.1 of Action 2 have thus been implemented. Given that most African countries do not have sophisticated administrative and banking systems, the use of hybrid mismatch arrangements is a lesser concern for them than for South Africa.

The Davis Tax Committee assessed South Africa's existing provisions to curb hybrid-based schemes to be satisfactory: 'One could say that hybrid mismatches are not of a major concern in South Africa for now'.[208] Interestingly, South Africa's recognition and early adoption of anti-hybrid abuse measures has not translated to increased co-operation and coordination with other jurisdictions other than exchange of information. This may be attributed to tax commentators' unwillingness to share their knowledge of hybrid mismatch arrangements with tax authorities in order to protect their clients from potential audits.[209]

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[206] *Ibid* 203, at pp. 3-4.
[207] South African Revenue Service 2016, *Government Gazette No. 40516, 23 December 2016.*, at p. 31.
[208] Davis Tax Committee 2017c, *Second interim report on base erosion and profit shifting (BEPS) in South Africa: Action 2: neutralise the effects of hybrid mismatch arrangements*, at p. 58.
[209] *Ibid* 100, at p. 42.

South Africa's Leadership Role

South Africa's position in the global economy is quite different to most African countries. It is both a developing country and more advanced than other African countries, placing South Africa in a leadership position for the developing world. As noted by Oguttu: [210]

> On the one hand, South Africa has a modern economy as portrayed by its financial sector; it is a residence state to many home grown MNEs [i.e. multinational enterprises] and it is a base country for many intermediary holding companies investing in the rest of Africa. Thus, BEPS action items that are pertinent for predominantly capital-exporting countries, such those on neutralizing the effects of hybrid mismatch arrangements, CFC rules, countering harmful tax practices and on TP (all explained below), are pertinent for South Africa.
>
> On the other hand, South Africa is still struggling to emerge from its roots as an unequal society. It relies heavily on FDI from developed economies and still applies exchange control regulations (EXCON) to regulate the outflow of funds from the country. Thus, BEPS measures that are pertinent to predominantly capital importing countries, such as those on limiting base eroding interest deductions preventing treaty abuse, preventing artificial avoidance of PE status and on ensuring that TP outcomes are in line with value creation […] are also pertinent for South Africa"

The Davis Tax Committee acknowledged that the impact of hybrid-based arbitrage may be different for developing countries and there is therefor a need to weigh the benefits of the Action 2 recommendations with a number of factors, including 'the technical requirements to trace and link deductibility of payments with treatment in the counterparty jurisdictions can be complex and resource intensive'.[211] There are a number of difficulties in translating the BEPS Project to the African paradigm: Even though BEPS is a global concern, the nature of BEPS concerns is not uniform for all countries. Certain BEPS schemes that work to undermine the European or American tax base often do not coincide with the African paradigm. Furthermore, BEPS does not address some practical

[210] *Ibid* 185, at p. 699.
[211] Davis Tax Committee 2017a, *Executive summary of second interim report on base erosion and profit shifting (BEPS): OECD BEPS project from a South African perspective: policy perspectives*, at p. 21.

matters such as withholding taxes which are very relevant for African countries in addressing BEPS. [212]

South Africa leads in the effort to translate the BEPS initiative to the African paradigm. The Minister of Finance appointed the Davis Tax Committee in 2013 'to inquire into the role of South Africa's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability'.[213] Other African countries are following the work of the Committee keenly and its work is therefore critical for regional and continental integration.[214]

South Africa has played a key role in ATAF efforts to engage the African community and provide a platform for the development of a unified African response to BEPS initiatives: 'ATAF has been mandated to define the African position with its members and to communicate the African response to the BEPS project. ATAF will be supported in that work by delegates from its member countries'.[215] In March 2014, the ATAF conference on the 'Global Tax Agenda and Its Implications for Africa' was held in Johannesburg. African officials from 29 countries deliberated an African response to the OECD BEPS initiatives, while focusing on the need to improve the administrative capacity, widen the tax base, and increase tax revenue in African countries. An African Working Plan was established to provide guidance on the African BEPS approach and input into the OECD BEPS process.[216]

In 2015 another ATAF conference was held in Johannesburg which focused on the African position on the 15 Action Items. Officials defined the Recommendations which are most relevant to the African paradigm. The South African Minister of Finance when speaking at the conference emphasised the need for a united African voice:[217]

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[212] *Ibid* 185, at p. 26-27.
[213] *Ibid* 202, at p. 1.
[214] *Ibid* 185, at p. 23.
[215] ATAF 2014b, *Cross-border taxation: Implications for Africa. African Priorities on Base Erosion and Profit Shifting (BEPS) and ATAF policy brief – December 2014*, at p. 6.
[216] *Ibid* 185, at p. 22.
[217] South African Government 2015, *Minister Nhlanhla Nene: African Tax Administration Forum conference on cross border taxation in Africa*, viewed 22 April 2021, <https://www.gov.za/speeches/page-1-11-speech-minister-finance-mr-nhlanhla-nene-ataf-conference-cross-border-taxation>

> Africa must protect its own tax base and advance Domestic Resource Mobilisation through a common voice, a common concern and a common action plan. The discussions that will be taking place here over the next two days provide an encouraging continuation of efforts in presenting coordinated African contributions to the international tax developments. The current global focus on international taxation offers a unique opportunity for African leaders to embark on their own continental taxation renaissance.

As a member of the G20 and a pivotal coordinator of the ATAF plans, South Africa plays a vital role in communicating the African voice to the OECD and other international bodies.

CHAPTER 7: ALTERNATIVE SOLUTIONS

GENERAL ANTI AVOIDANCE RULES

General anti-avoidance rules (GAAR) 'limit or deny the availability of undue tax benefits, for example, in situations where transactions lack economic substance or a non-tax business purpose'.[218] Put simply, they combat arrangements that comply with the letter of the law but not with its spirit or purpose. In concept, this is precisely what the OECD set out to achieve. The question follows: Could the GAAR displace the OECD's complicated and imperfect approach and be used to combat hybrid mismatch arrangements?

At first glance this seems an obvious remedy. The GAAR has the advantage of simplicity and flexibility. Its general wording makes it possible to apply the GAAR to various types of arrangements; however, this flexibility also leads to uncertainty for taxpayers as it remains to be seen how each jurisdiction will interpret and enforce their domestic GAARs. Thus, the simplicity of the GAAR is only an illusion.

To overcome this problem, the European Commission (EC) ingeniously proposed that multiple but common GAARs be adopted by EU member states:[219]

> To counteract aggressive tax planning practices which fall outside the scope of their specific anti avoidance rules, Member States should adopt a general anti-abuse rule, adapted to domestic and cross-border situations confined to the Union and situations involving third countries.

This represents a holistic approach to the problem than that presented by the OECD, as it encourages coordination between states without infringing on state sovereignty. In theory, the European Court of Justice (ECJ) would have jurisdiction over cases where the common GAAR is enforced, but in practice, it may not be so simple. It is questionable whether the ECJ would be competent to assess issues relating to the

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[218] *Ibid* 1, at p. 38.
[219] European Commission Recommendation C(2012) 8806 final of 12 December 2012 on aggressive tax planning, at p. 4, para. 4.1.

interpretation of domestic GAARs applicable to domestic situations.[220] This may instead lead to an increase in legal uncertainty and have a spill-over effect of the ECJ claiming jurisdiction over domestic tax issues involving the GAAR.

Legal gaps, such as those that lead to hybrid mismatch arrangements, cannot be overcome by a GAAR, since these provisions do not operate automatically or universally.[221] The onus to prove that the main or sole purpose of the arrangement is to gain a tax benefit rests with the state and requires demonstration on a case-by-case basis. This difficulty was acknowledged by the OECD in its Hybrid Report: [222]

> The terms of general anti-avoidance rules and the frequent need to show a direct link between the transactions and the avoidance of that particular jurisdiction's tax tend to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements.

Since most hybrid mismatch arrangements are well within the confines of the law and arguably in keeping with the spirit of the domestic law, specific anti-avoidance rules, such as the system of rules proposed in the Action Plan, would be far more effective: there is no responsibility to prove the purpose of the arrangement is avoidance as the burden of proof is shifted to the taxpayer.[223]

BILATERAL TREATIES

Harris observes that the hybrid problem is of a global nature, whereas the OECD's solution is a domestic one, with a focus on the overhauling of domestic legislation.[224] How can we expect further domestic legislation, which countries will not uniformly agree on, to solve the problem if taxpayers can continue to circumvent them through new gaps that are created through inconsistent implementation? Harris therefore suggests

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[220] *Ibid* 38, at p. 54.
[221] *Id* at p. 48.
[222] OECD 2012, *Hybrid mismatch arrangements: Tax policy and compliance issues,* at p. 13.
[223] Venetikoski, L., 2017. *EU approach to elimination of hybrid mismatch arrangements: Analysis under the objectives of Anti-Tax Avoidance Policy.* Tilburg: Tilburg University, at p. 12.
[224] *Ibid* 58, at pp. 659.

implementing change through bilateral treaties as an alternative method. Such an approach would have significant advantages:[225]

1. The OECD would only play an intermediary role, giving the organisation greater appeal and improving the chances of the proposal's implementation;
2. Bilateral treaties allow nations to bargain for some leeway commensurate with their unique circumstances and needs, while still creating regulatory change; and
3. Hybrid mismatch arrangements will be easier to trace and allow the relevant jurisdictions to reach coordinated solutions.

This approach is certainly more streamlined with a focus on co-operation, but it is limited by the nature of the DTA instrument. DTAs are concluded between two (or more) jurisdictions in order to remove tax barriers to the international flow of capital, primarily through the elimination of double taxation.[226] Some treaties do include anti-avoidance measures:

> Typical provisions include those specifically aimed at denying the benefits of the treaty to certain entities, provisions which are aimed at particular types of income, provisions which are aimed at preferential regimes introduced after the signature of the treaty and provisions designed to protect the tax base of countries concluding treaties with low-tax jurisdictions.[227]

None the less, a DTA cannot impose a tax liability, only provide relief from double taxation by restricting a tax liability. The denial of a deduction or imposition of a liability would still remain a matter of domestic legislation.

CO-ORDINATION-BASED SOLUTIONS

Parada slates the few alternatives to the Action Plan put forth by experts as unoriginal:[228]

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[225] *Id* at p. 660.
[226] Horak, W 2020, 'The conclusion and force of double tax agreements', In: De Koker, AP, ed. *Silke on International Tax*. Johannesburg: 2020, at § 12.4 The objectives of double taxation agreements.
[227] *Ibid* 1, at p. 38.
[228] *Ibid* 175, at p. 24.

> Nevertheless, equally questionable is the lack of serious alternative solutions proposed by either academics or tax policy makers, which demonstrates a sort of conformism as regards both the diagnosis of the problems and the existing solutions thereto, as if matching tax outcomes and taxing income somewhere – no matter where – were indeed the only possible path.

Indeed, the only truly creative alternatives are the co-ordination-based solutions explored in his work. Parada argues that the D/NI and DD outcomes addressed by the OECD's consequentialist approach are not necessarily interconnected to hybrid entity transactions, and therefore cannot serve each other in the design of domestic anti-hybrid entity provisions: neither the international need of single taxation nor the inconsistent characterisation of entities have been proven *a priori* a true concern.[229] The reason for the mismatch (inconsistent characterisation) has been relegated to the metaphorical background, and a path that is entirely different from that of co-ordination has been adopted in Action 2. A more straightforward approach would be to coordinate the tax characterisations of entities across jurisdictions, addressing the source of the problem directly. He presents three mutually exclusive possibilities:[230]

1. Supremacy of the tax characterisation rules of the source state;
2. Supremacy of the tax characterisation rules of the residence state; or
3. Supremacy of the tax characterisation rules of the home state.

While these options focus on the source of the problem instead of the double-taxation outcome, they are also very effective at creating a single taxation result.

Supremacy of the Tax Characterisation Rules of the Source State

This option would require all jurisdictions involved in the relevant transaction to characterise the reverse hybrid entity according to the characterisation of the source state i.e., the state from which the payment is generated. The outcome of this rule is illustrated below in Figure 8.

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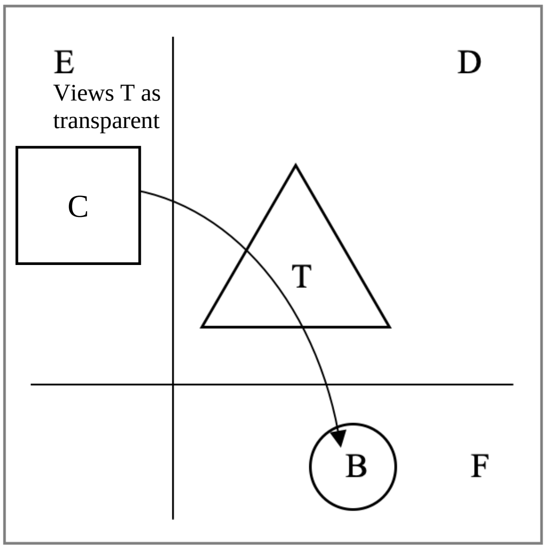
[229] *Ibid* 145, at Introduction, para 2.
[230] *Ibid* 175.

Figure 8: Application of the Supremacy of the Source State Characterisation Rule



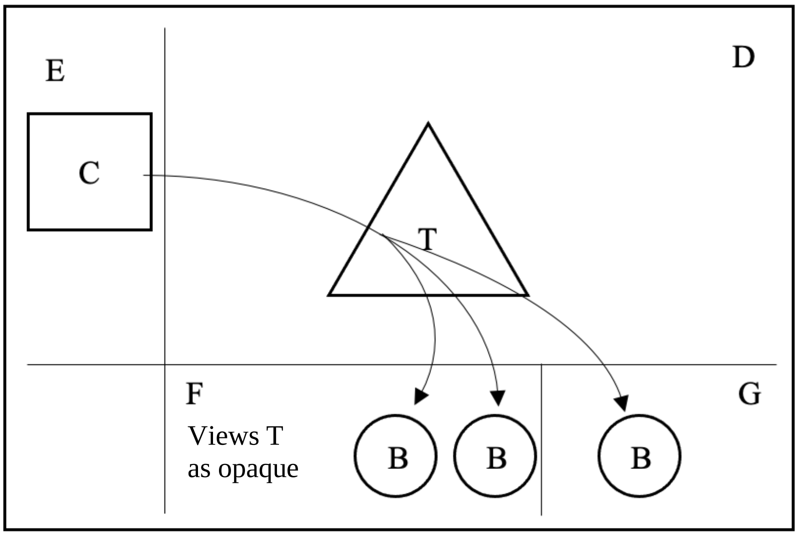
In Figure 8, a Company (C) in jurisdiction E is wholly owned by a Trust (T) in Jurisdiction D. The Company makes a dividend payment to the Trust, which then distributes the income to its Beneficiary (B) in jurisdiction F. When the rule is applied, both jurisdiction D and F must follow the characterisation of T in the domestic law of jurisdiction E, being the source state of the payment. If jurisdiction E views the trust as a transparent entity, the Company will be allowed a deduction for the payment in jurisdiction E, the Trust will not be liable for tax in jurisdiction D, and the beneficiary in jurisdiction F will include the payment in his income in jurisdiction F.

One downfall of this option is that nothing prevents jurisdiction D from enforcing CFC rules and which would give rise to potential double taxation. It would be possible to overcome this possibility in practice by allowing credits for taxes paid by beneficiaries.

Supremacy of the Tax Characterisation Rules of the Residence State

This option requires all jurisdictions involved in the relevant transaction to characterise the reverse hybrid entity in accordance with the domestic law of the residence state of the majority of the investors in the entity. The application of the rule is illustrated below.

Figure 9: Application of the Supremacy of the Residence State Characterisation Rule



In this scenario, the Company (C) which is wholly owned by the Trust (T) pays a dividend to the Trust, which then distributes the income to two beneficiaries (B) in jurisdictions F and one in jurisdiction G. As the majority of the investors reside in jurisdiction F, jurisdiction D, E, and G refer to the characterisation of the Trust provided by jurisdiction F. Since jurisdiction F views the Trust as opaque, dividend payment will be treated as ordinary income in all of the jurisdictions.

The application of this rule is particularly problematic with regard to trusts. In the example above, it is clear that the majority of investors are resident in jurisdiction F. As the number of investors increases, it becomes more difficult to establish the resident state with certainty. If the hybrid entity is a company, it may have hundreds of shareholders. If the hybrid entity is a trust with a class of beneficiaries, as opposed to specified individual beneficiaries, it may not even be possible to determine who the eligible beneficiaries are. The investors may also change from year to year if, for instance, a discretionary trust makes distributions or vests an asset in a beneficiary in that year.[231]

[231] According to Common Reporting System (CRS) procedures, a discretionary beneficiary only qualifies as a controlling person in years in which he received a distribution from a trust, or an asset was vested in him. See OECD 2018, *Standard for Automatic exchange of financial information in tax matters – Implementation handbook – Second edition*., at p. 19.

There is also the question of whether the settlor or trustee should be considered investors. If the trust is revocable or the settlor retains the power to remove the trustee and appoint new trustees, there is a real possibility that the settlor will benefit from the trust's income. On the other hand, the trustee clearly commands control of the trust assets, but does not economically benefit from it. If the trustee is assessed to be the majority investor, the outcome of the application of the rule will not reflect the economic reality.

There is also a concern that the recharacterization of an entity according to the residence of foreign nationals would unjustly impact the rights of resident investors and as a consequence would negatively impact international trade.[232] Resident investors may be hesitant to seek investment from foreign nationals if they run the risk that the tax transparency of their investment will not be respected in the future. Such a rule may even be considered discriminatory in view of EU fundamental freedoms. The 1957 Treaty of Rome which established the European Economic Community states:[233]

> The activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein
>
> (b) the establishment of a common customs tariff and of a common commercial policy towards third countries...;
>
> (f) the institution of a system ensuring that competition in the common market is not distorted.

Supremacy of the Tax Characterisation Rules of the Home State

Lastly, there is the option to give supremacy to the tax characterisation rules provided by the home state i.e., the jurisdiction of establishment. The application of the rule is illustrated below in Figure 10.

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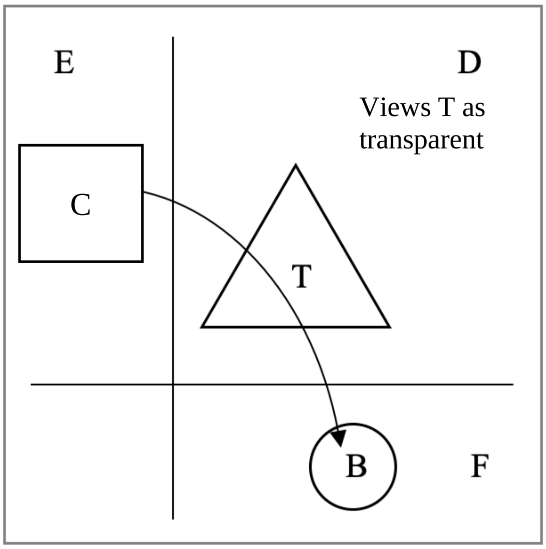
[232] *Ibid* 175, at p. 40.

[233] European Union 1957. *Treaty establishing the European Union, Rome Treaty, 25 March 1957,* at Article 2.

Figure 10: Application of the Supremacy of the Home State Characterisation Rule



In this scenario, jurisdictions E and F refer to the tax characterisation rules provided by the home state of the hybrid entity (jurisdiction D). Since the Trust is treated as tax transparent in its jurisdiction, the Company will be allowed a deduction in jurisdiction E and the beneficiary will include the payment in his income in jurisdiction F. This should be an acceptable outcome for those concerned with single taxation.

Parada notes that this option may be the most coherent and the simplest in terms of administration of the law[234] since in the context of a company, it is relatively easy to determine the establishment jurisdiction. As explored in detail in Chapter 3 under the header *Establishment Jurisdiction*,[235] the matter of determining a trust's establishment jurisdiction is highly complex and is dependent on a number of factors. Possible candidates that may be considered the determining factor are the proper law of the trust, the place of residence of the trustee, and the place of residence of the settlor. Since states have divergent rules that affect the state that they consider the establishment jurisdiction, this option does not appear to be the best choice in regard to trust-based hybrid arrangements.

[234] *Id*
[235] See pp. 25-30.

Another potential downfall of this option is that it may incentivise legislators to introduce provisions that characterise hybrid entities in such a way that it attracts investors seeking new abusive practices.

The possibility exists that each of these solutions may result in a triangular result, for instance if CFC rules are applied in addition to the co-ordination rule. Parada suggests that when legislating the rules, states include the option to suspend the adopted rule in certain situations. States would need to reach a consensus as to which of the above options is the most preferable. The approach can only be successful if a chosen rule is uniformly adopted.

Parada's suggestion certainly would entail a fresh and more coherent revision of the international tax system, but it overlooks the importance of state sovereignty, much like the OECD linking rules. It is naïve to think that a state would happily ignore its own characterisation rules in favour of a foreign state's rules and potentially forgo tax revenue. It is also true that the application of any of the options on trust-based hybrid arrangements would be more multifaceted and challenging than the OECD Recommendations – not much is gained in this respect.

THE ANTI TAX AVOIDANCE PACKAGE

In light of the political pressure to combat BEPS, the EC declared its intention to tackle aggressive tax planning.[236] In January 2016, the EC released a proposal for the Anti Tax Avoidance Package (ATAP) with the objective to transpose the OECD BEPS Recommendations in a coordinated manner to the EU level. The proposal and subsequent Directives encompassed six fields: the deductibility of interest, exit taxation, a switch-over clause, a GAAR, CFC rules, and a framework to tackle hybrid mismatch arrangements.[237] It seems that the EC set out with the objective of creating a more fundamental approach to the issue of hybrid mismatch arrangements, but due to political pressure succumbed to the consequentialist approach.[238] In addition, the Council's ability to impose binding measures grants it the opportunity to implement a more ambitious plan.

[236] European Commission 2012, *Commission recommendation of 6.12.2012 on aggressive tax planning*.
[237] *Ibid* 245, at p. 3.
[238] *Ibid* 175, at p. 49. See also *Ibid* 120, at p. 40.

Accordingly, EC set out with the intention of ensuring that tax liabilities are generated in the jurisdiction where economic activity takes place:

> The objective of the Anti-Tax Avoidance Package is to enhance the smooth functioning of the Single Market and thereby support the ability of the Single Market to secure sustainable growth, employment and competitiveness. A fair, efficient and growth-friendly corporate taxation is a key element of a strong Single Market. It should be based on the principle that taxes are paid in the country where profits are generated. [239]

The Council adopted ATAD 1 in its meeting on 12 July 2016 but this final version did not achieve the EC's lofty objectives.

The EC's differing approach to the BEPS issue perhaps stems from the EU's emphasis placed on the right to freedom of establishment.[240] As discussed in Chapter -, the OECD's concept of aggressive tax planning is an extra-legal concept which blurs the line between tax avoidance and tax planning. The right to make use of differences between tax systems and to create the most favourable tax outcome has been reinforced many times by the ECJ, most notable in the *Centros,*[241] *Überseering*[242] and *Inspire Art*[243] cases.

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[239] European Commission 2016b, *Commission staff working document accompanying the documents Communication from the Commission to the European Parliament and the Council – anti tax avoidance package: next steps towards delivering effective taxation and greater tax transparency in the EU,* at p. 24. See alos European Commission 2015, *Communication from the Commission to the European Parliament and the Council: a fair and efficient corporate tax system in the European Union: 5 key areas for action*, at p. 6.

[240] Vanik M 2017, '(Reverse) hybrid entity mismatches in EU', Tilburg: Tilburg University., at p. 2

[241] *Centros Ltd v Erhverve-og Selskabsstyrelsen.* (1999) Case C-212/97. ECLI:EY:C:1999:126. To avoid minimum capitalisation rules, two Danish nationals established a company under UK law and traded solely in Denmark. This was considered unlawful by the Danish commercial registry. The ECJ found that where a company exercises freedom of establishment, Member States are prohibited from discriminating against this company.

[242] *Überseering BV v Nordic Construction Company Baumanagement GmbH* (NCC) (2002) ECLI:EU:C:2002:632. The ECJ held that TEC articles 43 and 48 (now TFEU articles 49 and 54)precluded German courts denying legal capacity to companies like Überseering BV, because it was fundamental that states recognised companies incorporated abroad, regardless of whether member states had conventions on mutual recognition of companies. Despite a change in ownership, Überseering BV was still a valid company in the Netherlands. There was no countervailing justification by any overriding requirements relating to the general interest to not uphold the right of freedom of establishment.

[243] *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*. (2003) Case C-167/01. ECLI:EU:C:2003:512. The ECJ rules that Dutch rules of minimum capitalisation for LLCs could not be enforced on Inspire Art Ltd, registered in England by a Dutch national. This reinforced the view in favour

Several aspects of the ATAD 1 and ATAD 2 are similar to the co-ordination-based approaches explored by Parada, and this similarity is noted in his work as support for his approach. Article 10(1)[244] of the Proposal is similar to Parada's 'supremacy of the tax characterisation rule of the source state' option. It focused on the treatment of hybrid transactions which result in a D/NI outcome. EU Member States are directed to coordinate their tax treatment of the transaction according to the states from which the payment is generated:

> Where two Member States give a different legal characterisation to the same taxpayer (hybrid entity), including its permanent establishments in one or more Member States, and this leads to either a situation where a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State or a situation where there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the legal characterisation given to the hybrid entity by the Member State in which the payment has its source, the expenses are incurred or the losses are suffered shall be followed by the other Member State.[245]

The rule is mechanical in nature, meaning that it is only triggered where a payment is deductible without a corresponding inclusion, indicating that the approach is still consequentialist.

Article 9 of ATAD 1 addresses hybrid-based mismatches:

> 1. 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 has its source.

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of freedom of establishment that submitting foreign companies to the company law of a host state is impermissible.

[244] *Ibid* 175, at p. 31-32.

[245] European Commission 2016a, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market: 2016/0011(CNS)*, at p. 21.

2. 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.

The Directive does not include a defensive rule, making it a far simpler proposal. This may be attributed to the fact that it is mandatory for EU states to implement the rules. If the rules are uniformly implemented across the EU, there is clearly no need for a defensive rule as the primary rule will always be implemented. However, if one state were to incorrectly implement or misinterpret the Directive, this would expose other states to the possibility of hybrid mismatch arrangements once again.

Transactions involving non-EU jurisdiction fell outside of the scope of the ATAD 1, which aimed to reduce obstruction within the internal market. This added further complications to compliance and administration. The Directive was thus expanded to apply to transactions involving jurisdictions outside of the EU in the amended Anti Tax Directive (ATAD 2) which aimed to rectify shortcomings of the first Directive and to react to the BEPS Recommendations of the OECD which would have a global impact:

> It is necessary to establish rules that neutralise hybrid mismatches in as comprehensive a manner as possible. Considering that Directive (EU) 2016/1164 only covers hybrid mismatches that arise in the interaction between the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 2016 requesting the Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.[246]

Reverse hybrid entities are addressed in Article 9a and Article 9(2). Article 9a of ATAD 2 supports the second option put forth by Parada to give the tax characterisation rules of the resident state (the jurisdiction of the majority of the investors) supremacy. It addresses payments received by a reverse hybrid entity resulting in a D/NI outcome, specifically

[246] Council directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, at L 144/1-2.

where the majority of the investors in the entity reside in a non-EU state that views the trust as opaque:

> Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 per cent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction.[247]

Article 9(2) brings the Directive closer to the OECD linking rules by adding a defensive aspect:

> To the extent that a hybrid mismatch results in a deduction without inclusion:
>
> (a) the deduction shall be denied in the Member State that is the payer jurisdiction; and
>
> (b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in income in the Member State that is the payee jurisdiction.

Interestingly, the EC gives higher priority to Article 9a than to 9(2) which contains a similar mechanism to the OECD linking rules. Meaning that the EC views the linking rules as unnecessary if a co-ordination approach can be achieved.[248]

While the EC departed from the OECD in their original approach, they have not succeeded in addressing the core issue of inconsistent characterisation since the Directive

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[247] *Ibid* 246, at Article 9a(1).
[248] *Ibid* 175, at p. 42.

is only triggered when a D/NI or DD result occurs: 'to the extent that the income is not otherwise taxed under the laws of the Member State or any other jurisdiction'.

The binding nature of the Directive sets it apart from the OECD Action 2, which contains soft recommendations. On 29 May 2017 the Council adopted ATAD 2 which were required be transposed into Member States' national laws and regulations by 1 January 2020, with the exception of the rules targeting reverse hybrid entity mismatches, which need to be enacted by 1 January 2022.[249] It is foreseeable that the approach taken by the EC may displace that of the OECD given that Member States will be forced to implement in the near future and this may motivate countries that wish to maintain a strong trade relationship with EU states to enact similar provisions. The Directive is essentially a stripped-down, simpler version of the OECD Plan which may also make it a more attractive option to legislators wishing to show a contribution to the anti-BEPS fight.

[249] Ibid 246, at L144/9-10.

CHAPTER 8: CONCLUSION

Due to its focus on the notion of single taxation, the OECD has not only deviated from the real goal (remedying inconsistent characterisation of hybrid entities) but has also set the tax community on a difficult and uncertain path that may likely result in failure. The research has demonstrated that this path is unsuitable from both a theoretical and practical standpoint. The OECD has overlooked essential parts of the single taxation principle in their haste. Single taxation can only truly be achieved if taxation is levied in the jurisdiction where the economic activity is carried out. The Action Plan, on the other hand, is only concerned that income is taxed at least once, regardless of which state receives the revenue. The premise of the plan is faulty, and as a result the practical aspect of the plan is highly problematic. Legislators are now faced with the daunting prospect of interpreting and administrating a complex web of rules that are at times contradictory. There can be no doubt that leaders must be disappointed that the promised comprehensive and cohesive change was not delivered.

It is clear that OECD did not pay much attention to how their complicated system would apply to trust-based hybrid mismatches. The Recommendations are most relevant to trusts in arrangements in which the trust acts as a reverse hybrid entity. Recommendations 4 and 5, therefore, have the widest application. They appear to be drafted on the basis of a corporate hybrid entity, and the meaning of the rules can be difficult to interpret in the context of a trust. For example, the establishment jurisdiction may be one of a number of possibilities, and the settlor may or may not qualify as an investor. Furthermore, the Recommendations do not incorporate an appreciation of the distinctive attributes of trusts, which routinely trigger mismatches.

The complex nature of the OECD solution has led to a slow convergence from the international tax community. A few states have implemented broad anti-abuse measures both the majority have adopted a wait-and-see attitude. This reaction was inescapable since legislators are not guaranteed that once they implement the Recommendations, other states will follow suit. Those countries who are first to implement run the risk that they will not be able to attract foreign investment due to the inhospitable economic environment created.

Remaining an attractive investment destination is of particular concern to developing countries. It is highly evident that the concerns of developing countries were not taken into consideration during the drafting process; it is outlandish to expect that the states will be able to correctly interpret and administer the OECD Recommendations given their lack of expertise in the international tax sphere. The OECD has failed to address how difficulties in the implementation process can be alleviated, but South Africa has assumed a key leadership role in the African community in translating the BEPS issue to an African paradigm, as well as conveying the African viewpoint to international bodies.

Given the clumsiness of the Action Plan, it is necessary to assess whether alternative solutions would be more effective. Parada's co-ordination-based approach offers the most innovative and cohesive alternative, but the options have flaws that need to be addressed. Further discussion would be required especially with regard how the supremacy of the residence and home state characterisation rules would apply to trusts. ATAP can also be seen as an alternative to the OECD Plan. The EC attempted a more cohesive approach targeting the source of the mismatch issue, as opposed to the symptoms of the issue. The Directives that resulted disappointingly did not achieve this. Notably, EU states are required to implement the measures pertaining to reverse hybrid mismatch arrangements in 2022. The binding nature of ATAP could potentially result in the EU approach displacing that of the OECD and contribute to the failure of the Action Plan.

It was questioned at the launch of the OECD/G20 BEPS initiative as to whether this will be the starting point for the development of new principles of international tax law or whether it will be the final failure of the OECD to gain consensus on topics, notwithstanding the unprecedented level of political support.[250] The dominance of the OECD in the international tax regime depends strongly on their ability to successfully reach an agreement on and impose a solution to the BEPS issue: 'If they fail to do this—if it becomes apparent that even within the OECD it is impossible to reach agreement on solutions—the leadership and the legitimacy of the OECD in tax matters will have been fatally undermined'.[251] The organisation's strength has already faltered as a result of the

[250] Panayi, CHJI, 2016. International tax law in the post-BEPS world. *Bulletin for International Taxation,* November, 70(12), at p. 655.
[251] *Ibid* 19, at p. 605.

increasing power and influence being absorbed by emerging economies. The member nations of the OECD have experienced a considerable loss of power to MNEs that are gradually less dependent on these powers due to globalisation. Judging by limited implementation that Action 2 has seen internationally, it is feasible that the OECD will not succeed in enforcing change and an opening will be created for a different international body to assume a leadership role in the international tax community.

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