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Avoiding Tax using Hybrid Mismatch Arrangement Schemes in Indonesia

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Abstract—**The present study investigates the habit in Indonesia of avoiding tax by means of hybrid mismatch arrangement schemes. A qualitative approach and data collection by means of library and field study was adopted in the present study. In-depth interviews were done with key respondents representing practitioners, academics, and tax authorities in Indonesia. The key result of the present study indicates that the habit of avoiding tax using hybrid mismatch arrangement schemes in Indonesia typically used debt/equity hybrid (financial instrument) by involving Indonesian corporations as payer. In addition, hybrid transfer and imported mismatch schemes prevail in Indonesia. Although there is no evidence of substitute payment and payment made to reverse hybrid schemes, these schemes are likely to be used in Indonesia under the current regulations and the taxation system. In general, the practice of tax avoidance using hybrid mismatch arrangement schemes in Indonesia is still limited.**

Keywords—tax avoidance; Base Erosion and Profit Shifting (BEPS); hybrid mismatch arrangements; hybrid financial instruments; tax arbitrage

I. Introduction

In a globalized world with increasing integration of economies, cross-border investments and transactions simultaneously enable the interaction of tax systems. Hybrid mismatch arrangements can be created to benefit from these interactions. In other words, it relates to arrangements that exploit the differences in the tax treatment of an entity or instrument under laws of two or more tax jurisdictions to achieve double nontaxation, including long-term deferral [1]. To mitigate this problem, the Organization of Economic Co-operation and Development (OECD) and the G20 (of which Indonesia is a member state) include the "Neutralizing the effects of hybrid mismatch arrangements" in Base Erosion and Profit Shifting (BEPS) Project, namely BEPS Action Plan 2.

According to the initial investigations by the United Nations (UN) through Financing for Development Office (FfDO), "Neutralizing the effects of hybrid mismatch arrangements" is one of the nine principal issues for protecting the tax bases for developing countries [2]. This is consistent with the studies by [3], who sought the perceptions and opinions of experts in the field of international taxation originating from OECD, Brazil, Russia, India, China, South Africa (BRICS), and developing countries. Consequently, BEPS Action Plan 2 is ranked 2 out of the 10 Action Plan (first rank is Actions 8–10, which are considered as one, while Actions 1, 11, and 15 are not considered) as the most significant as opined by international tax experts from developing countries.

As a developing country, Indonesia is likely to be exposed to the risks of base erosion arising from hybrid mismatch arrangements. However, the regulation and the taxation system of each country varies; therefore, there is a need for an Indonesia-specific perspective under the current regulations and the taxation system. There are few studies on hybrid mismatch arrangements in Indonesia [4-6]. However, they only discuss one of the underlying elements in hybrid mismatch arrangements, that is, hybrid financial instruments. Therefore, the purpose of the present study is to ascertain the hybrid mismatch arrangement schemes used in Indonesia, along with all the possible underlying elements using different tax treatments of an instrument or entity. The study results can help the tax authorities to in policy making to address issues of tax avoidance using hybrid mismatch arrangements in Indonesia.

This paper provides the introduction to hybrid mismatch arrangements and the underlying elements, followed by the research methods, data analysis, and scope of study. The study results stating the hybrid mismatch arrangement schemes used in Indonesia are presented, followed by analysis and discussion related to the limited number of tax avoidance using hybrid mismatch arrangement schemes in Indonesia and finally the conclusion of the study.

II. Literature Review

"Hybrid" refers to anything consisting of two or more different elements [7]. In this present study, it is disagreement between two countries on the classification or characterization of an arrangement necessary for tax purposes [8]. [9] describes the term "hybrid" as an entity, instrument, or transaction with different characterizations under different jurisdictions.

"Mismatch" refers to a difference between different viewpoints between two countries, which results in inconsistent outcomes when viewed as a whole [8], such as:

(a) Deduction/no inclusion (D/NI) outcome

This arises when a payment be a deduction (reduction in income on which the tax is calculated) in payer jurisdiction but not treated as ordinary income in payee jurisdiction.

Ordinary income is the income that is taxed at full rate without any tax benefit, including indirect tax credit on taxes paid by subsidiaries [1].

(b) Double Deduction (DD) outcome

A payment gives rise to DD outcome if there are two deductions (in two different countries) in respect of the same payment [1]. In other literature, it is known as double dipping.

(c) Indirect D/NI outcome

A payment generates indirect D/NI outcome if it is a deduction in the payer jurisdiction but offset by a deduction arising from a hybrid mismatch arrangement in another jurisdiction by the payee [1].

"Arrangement" refers to a contract, agreement, understanding, plan, or scheme, whether enforceable or not, including all steps and transactions by which it is applies [1]. [10] terms "hybrid arrangement" as a situation of two countries having different and inconsistent positions with respect to the tax treatment of an arrangement.

Countries or jurisdictions often differ in fundamental blocks in determining income tax, such as the type of transactions, the classification of instruments and the returns it generates, when and where transactions are made, how much income or expenses should be recognized, to what year they should be allocated, and who is the tax subject [11].

Often the key motivations for using hybrid instruments are to obtain lower costs of financing, greater financial flexibility, and a better credit rating [12]. However, often, hybrid arrangements are substituted for arrangements involving a tax haven entity, because it can achieve similar results without using a tax haven [10].

Tax arbitrage is tax optimization using hybrid arrangement. It is an economic concept, referring to benefitting from exploiting price differences on different markets [13]. In analogy, tax arbitrage is benefitting from the inconsistencies between tax laws in different countries to achieve greater profitable results than would be if investing in one jurisdiction [14]. Thus, hybrid mismatch arrangements hold a significant role in realizing tax arbitrage. However, a few researchers contend that tax arbitrage is just a tax optimization tool. It is not tax avoidance if it is in accordance with the business activities and is not solely to obtain tax benefits [13]. However, it is considered tax avoidance if it is not in accordance with business activities and is solely or dominated to obtain tax benefits.

Underlying elements generally the basic features used in hybrid mismatch arrangements as follows:

(1) Hybrid Financial Instruments

In general, debt and equity are the two basic forms of external financing for a company. Both of the forms have certain distinct characteristics. However, owing to certain economic and financial conditions as well as risk considerations, companies often have to combine the characteristics of both debt and equity to meet company or investor expectations. Therefore, hybrid financial instruments, securities containing both debt and equity, were introduced, which can be described as a bond with the features of equity or a share with the features of debt [7].

Although hybrid financial instruments can combine the characteristics of both debt and equity in several ways, the tax system generally only categorizes financial instruments as debt or equity. Therefore, two or more jurisdictions may have different methods in classifying a hybrid instrument. The most common examples of hybrid financial instruments are convertible debts, participating debts, subordinated debts, perpetual debts, preferred or preference shares, redeemable preference shares, and silent partnership [9].

(2) Hybrid Transfer

According to [15], a hybrid transfer is a transaction that is treated as a transfer of asset ownership for tax purposes in a country but is considered as a secured loan in another country. In the Action Plan 2: Final Report, [1] defines hybrid transfer as an arrangement involving the transfer of financial instruments; however, the difference in treating the arrangement for taxes resulting in such financial instruments are treated as those owned by two or more taxpayers. Examples of hybrid transfer are repurchasing transaction (repo), share lending arrangement, and bond lending arrangement.

(3) Hybrid Entity

those having the features of both corporate and non-corporate entities [16]. [15] defines hybrid entity as that which is treated as fiscally transparent for tax purposes in one country and as nontransparent in another country. Partnership firm is an example of a hybrid entity. Treatment as a transparent entity (or the so-called flow-through entity) implies that a tax jurisdiction will not impose a tax at the partnership level, but at the partners level [17]. In the transparent tax regime, a partnership is only a business vehicle of the partners, therefore the obligation to pay the tax lies with the partners concerned. Conversely, as a nontransparent entity, the tax is imposed at the partnership level, and does not affect each partner [17]. In this approach, the partnership is treated as a separate taxable entity like a corporation.

Besides, in addition to partnerships, trusts and other similar fiduciary relationships may become hybrid entities because they are treated as an entity by common law countries but not by civil law countries [10]. There are also other examples of hybrid entities, such as Limited Liability Partnerships (LLP) and Limited Liability Company (LLC) [16].

Fundamentally, there are two types of hybrid entities: classic and reverse. The classic hybrid (often called the hybrid entity) is an entity treated as transparent in the country where its owner is located but treated as a separate tax entity in the country where the entity is established [16]. If the entity is owned by only one person or a member, it is called "disregarded entity." This is treated as a branch, division, or sole proprietor for tax purposes in the country where its owner located [9]. By contrast, reverse hybrid entity is treated as separate in the country where its owner is located but transparent in the country where it is established [16].

(4) Dual Resident Entities

Definition of the term resident is not regulated in tax treaties (either OECD or UN Model); however, it appears in the domestic law of each country [18]. Thus, by this definition, an entity is allowed to become a domestic taxpayer in two different countries (i.e., a dual resident entity). A dual resident company can reduce the tax burden by double dipping such that a single payment is deducted twice in two different countries/jurisdictions. This is possible if both jurisdictions allow the consolidation of profit and loss of the related companies in their respective jurisdictions [19].

III. Research Methodology

The present study adopted a qualitative approach for in-depth understanding of a problem [11]. This descriptive research provides a detailed picture of a specific situation or phenomenon [20]. The present study describes the practice of tax avoidance using hybrid mismatch arrangement schemes in Indonesia.

The following techniques and data collection methods were used:

a) Library Study

Library study analyzed various hybrid mismatch arrangement schemes featured in a number of books, literature, journals, articles, and other research to arrive at a theoretical framework for this study. In addition, the regulations and the taxation system currently applied in Indonesia were analyzed.

b) Field Study

Field study through in-depth interviews with competent key respondents in the field of international taxation was carried out to provide a comprehensive understanding of the problems of hybrid mismatch arrangement in Indonesia. Semi-structured interviews were held with competent key respondents representing practitioners, academics, and Directorate General of Taxes (DGT) as the tax authority in Indonesia who had knowledge of hybrid mismatch arrangement problems in Indonesia.

Questions relevant to the use of hybrid mismatch arrangements were examined. Moreover, the literature review included study of abstracts of field study data and patterns contained in the data obtained, which helped in the research problem solving.

In order to make this the present study focused on the following:

a) This study only discusses the mismatch generated due to differences in classification and tax treatment of an entity or instrument (hybrid mismatch arrangement), whereas mismatches arising from differences in tax treatment of revenue and expense allocations between branch offices and headquarters (branch mismatch arrangement) as per the final report issued by OECD in 2017 were excluded.

b) This study only discusses Indonesia's domestic law and does not include Double Taxation Convention (tax treaties) issues.

IV. Results

In general, the practice of tax avoidance using hybrid mismatch arrangements in Indonesia is still limited. Based on in-depth interviews with key respondents, debt/equity hybrid (financial instrument) is more common among Indonesian corporations as the payer. Moreover, hybrid transfer and imported mismatch schemes are also common in Indonesia. Although there is no evidence of substitute payment and payment made to reverse hybrid schemes, these schemes are likely to be used in Indonesia under the current regulations and the taxation system. Detailed information about the hybrid mismatch arrangement schemes is presented as follows.

A. Debt/Equity Hybrid (Financial Instrument)

Figure 1 illustrates debt/equity hybrid. A Co (resident in country A) owns almost all the shares in Ind Co (resident in Indonesia). Ind Co issues a hybrid financial instrument to A Co. The instrument is treated as a debt under Indonesian law, that is, Indonesian Statement of Financial Accounting Standards (SFAS) Number 50 (Pernyataan Standar Akuntansi Keuangan/ PSAK 50) concerning Financial Instrument: Presentation, therefore the (interest) payments are treated as a deductible expense for Ind Co. Meanwhile, country A classifies the instrument as equity, and the payment (which is considered as a dividend in country A) is exempt from tax due to participation exemption. Thus, this transaction results in D/NI outcome, which results in the lowest tax expense when compared to that if the instrument is treated consistently.

Participation exemption is normally applied to dividends from direct (e.g., nonportfolio) investment and is conditional on the minimum percentage amount of share ownership or voting rights. It is used to avoid economic double taxation on intercorporate dividends [9]. In addition to participation exemption, other shareholder relief systems, such as imputation system, indirect foreign tax credit, and reduced dividend tax rate, also result in a "no inclusion" outcome. In this scheme, the payee (lender) will manage the instrument such that it is classified as equity and benefits from the shareholder relief system. Otherwise, the payer (borrower) will manage the instrument such that it is classified as a debt and the payment under the instrument is deductible in Indonesia.

If Indonesia is in the opposite position, i.e. By contrast, as a payee, the payments under the instruments will not result in "no inclusion" because Indonesia does not exempt foreign dividends (dividends received from abroad). Tax relief is provided only for withholding tax on foreign income through ordinary credit method.

Concerning the regarding withholding tax on interest payments or dividends, [1] states that the function of withholding tax in payer (source) country is not typically to address mismatch in tax outcome. Thus, a payment cannot meet the criteria of inclusion in ordinary income only because it has been subject to withholding tax in the source country.

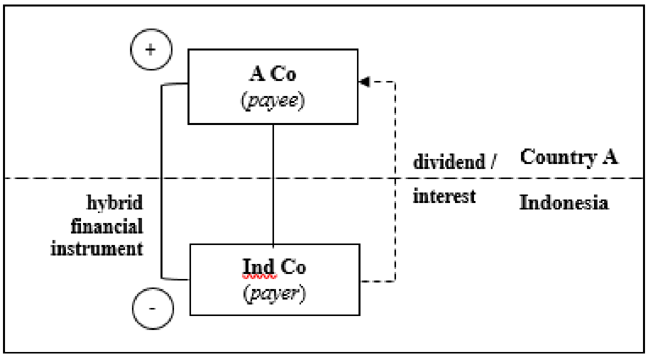

Fig. 1. Debt/Equity Hybrid

B. *Imported Mismatch*

Mismatch (D/NI outcome) created overseas, for example, by using debt/equity hybrid in other countries, can be brought to a third country (payer jurisdiction) by a nonhybrid instrument such as an ordinary loan. Since it is imported from other countries, this scheme is called an imported mismatch, whereas the resulting mismatch is called indirect D/NI. The scheme is also found in Indonesia, as revealed in the Luxembourg Leaks (LuxLeaks).

Figure 2 illustrates the scheme used. Indonesia Co is a large multinational subsidiary in the telecommunications sector that needs huge funds for infrastructure. If the loan is granted directly, Holdco (country A resident) will be subject to a tax on interest income in country A. Therefore, Holdco establishes a subsidiary in Luxembourg (Lux Co) with preference share in its capital structure. Then, Lux Co requests an advance ruling to the Luxembourg tax authority to treat the preference share as debt so that the payment under preferred share to Holdco is treated as interest and becomes deductible. Meanwhile, country A still considers preferred share as equity; therefore, in accordance with the laws of country A, dividend income received by Holdco is not taxed because dividends are exempted from tax under country A law.

It is assumed that Indonesia Co has income from business as 30, the interest paid to Lux Co is 10, and the interest/ dividend paid by Lux Co to Holdco is 9. If the tax rate in Luxembourg and Indonesia are 15% and 25%, respectively, the tax and after-tax return calculations are as follows.

The calculation in Table 1 shows that, on interest income of 10, Holdco and Lux Co obtained a combined after-tax return of 9.85, meaning that it is taxed effectively by 1.5%. It can be attributed to the existence of the Luxembourg conduit. The Luxembourg conduit is used to take payments that are deductible at source jurisdiction and send them to the residence jurisdiction as nonincludable tax returns [21].

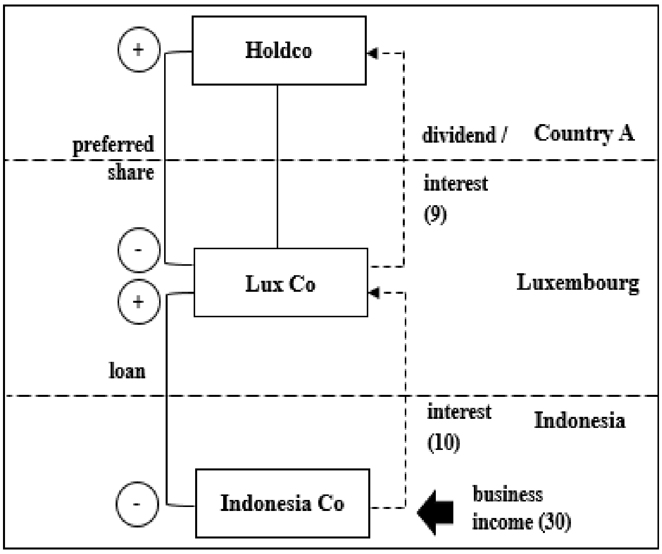

Fig. 2. Imported Mismatch

TABLE I. TAX AND AFTER-TAX RETURN CALCULATIONS FOR IMPORTED MISMATCH

Lux Co			Indonesia Co		
	Tax	Book		Tax	Book
Income			Income		
Interest received	10	10	Operating Income	30	30
Expenditure					
Interest Expense	(9)	(9)	Expenditure		
			Interest Expense	(10)	(10)
Net return		**1**	**Net return**		**20**
Taxable income	**1**		**Taxable income**	**20**	
Tax (15%)		**0,15**	Tax (25%)		**5**
After-tax return		**0,85**	**After-tax return**		**15**
Holdco					
	Tax	**Book**			
Income					
Dividend received	0	9			
Expenditure					
Net return		**9**			
Taxable income	**0**				
Tax		**0**			
After-tax return		**9**			

C. *Hybrid Transfer*

Hybrid transfer is often termed as collateralized loan arrangements [22]. Hybrid transfers occur when two parties are located in different jurisdictions, and each party is considered the owner of the (guaranteed) asset under the laws of each jurisdiction (Table 2).

An illustration of repurchase agreements (repo) that results in a hybrid transfer is seen in Figure 3. A multinational company in Indonesia (Indo Co) has several subsidiaries. Indo Co sells a shareholding of one of its subsidiaries (Subs Co) to its affiliated company (B Co) in country B. In the agreement between Indo Co and B Co, there is a repurchase clause whereby Indo Co will acquire those shares at a future date for an agreed price. The share of Subs Co are not traded on the stock exchange.

In the net paying repo transaction, B Co as the lender and the temporary owner of the shares of Subs Co retains (does not transfer) the dividend received from Subs Co to Indo Co. It is assumed that Subs Co pays dividend of 70 to B Co, while the purchase price and sale of shares are set at the same price such that B Co does not recognize the capital gain. The tax calculation and after-tax return are as follows.

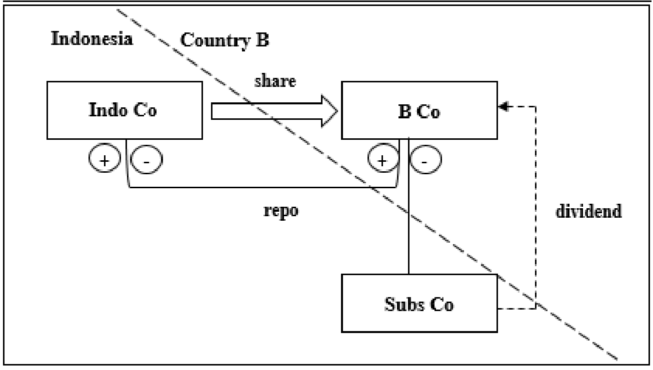

Fig. 3. Repurchase Agreements (Repo)

TABLE II. TAX AND AFTER-TAX RETURN CALCULATIONS FOR HYBRID TRANSFER

Indo Co			B Co		
	Tax	Book		Tax	Book
Income			Income		
Dividend	0	70	Dividend from Subs Co	0	70
Expenditure			Expenditure		
Interest Expense	(70)	(70)			
Net return		**0**	**Net return**		**70**
Taxable income	**(70)**		**Taxable income**	**0**	
Tax benefit (25%)		**17,5**	Tax		**0**
After-tax return		**17,5**	**After-tax return**		**70**

Consistent with Indonesian SFAS Number 55 (PSAK 55) about Financial Instrument: Recognition and Measurement, Indo Co still recognizes the investment in Subs Co because it has not met the terms of derecognition. Therefore, this transaction is treated as a loan transaction in accordance with its substance. Indo Co is considered as the owner of Subs Co such that the dividends distributed are recognized by Indo Co and are not taxable since Indonesia presents participation exemption as per Article 4 paragraph (3) letter f of the Income Tax Law for dividends received from an Indonesian LLC (domestic dividends). However, Indo Co does not receive the dividends as B Co retains it. Therefore, Indo Co recognizes the dividends as interest expense, which will be deducted (assuming the loan is used for activities related to obtaining, collecting, and maintaining income, which is a tax object).

However, country B treats the transaction based on its legal form such that B Co is treated as if it is the beneficial owner of dividends received from Subs Co (and not as interest like country A does). Country B also gives participation exemption for the dividends. Thus, this repo structure generates a D/NI outcome mismatch. In addition, a hybrid transfer is capable of creating duplicates in tax credits that are often known as foreign tax credit generators, for example, if the withholding tax on dividends is credited by both Indo Co and B Co.

However, in Indonesia, repo is also used for another purpose, that is, to recognize the unrealized loss of property due to reduction in the fair value of the property. To be able to realize the losses owing to the decline in share price of a subsidiary in tax calculation, a parent company sells the shares first and then repurchases them at a future date. This scheme is known as "tax loss harvesting." However, to recognize the unrealized loss, the parent company must design this scheme to qualify for the terms of derecognition as stipulated in Indonesian SFAS Number 55 (as opposed to the hybrid transfer arrangement described earlier).

D. Substitute Payment

A substitute payment is any payment, made under an arrangement to transfer a financial instrument, to the extent, that includes or represents a financial or equity return on the underlying financial instrument [1]. Based on the interviews conducted, no informant had observed this scheme in Indonesia. However, with the current regulation and tax system in Indonesia, this scheme is likely to be used.

Figure 4 illustrates a substitute payment. B Co (resident in country B) sells bonds issued by Issuer Co to Ind Co (resident in Indonesia). The bonds are issued at par value of 20 million and they bear interest at 12% (equal to market rate) paid semi-annually. Ind Co buys the bonds 4 months after the last interest payment. In addition to the acquisition cost of the bonds, Ind Co also pays a premium of 0.8 million reflecting the accrued but unpaid interest.

Table 3 shows that the payment of premium 0.8 million by Ind Co is treated as a deduction. However, as the recipient, B Co considered the premium as a gain of bond disposal that is exempt from taxation. Therefore, the transaction generates a D/NI outcome.

In addition to the sale of bonds with premium, substitute payment can give rise to D/NI outcome in the following transactions:

a) A share sale contract for which the settlement (payment) is made several years later. In addition to the stock price (which is determined based on the market price at the time the contract is agreed), the buyer must also pay the interest calculated from the market interest rate multiplied by the unpaid share price. For buyers, such interest can be deductible with income (In Indonesian SFAS Number 55, transaction costs incurred to acquire financial assets at fair value through profit or loss (FVTPL) may be charged directly). Regarding the seller, the income is treated as income from the sale of asset (not as interest income) (Example 1.27) [1].

b) Sale of shares in the mid of issuer accounting period. The purchase price of the shares (at market price) has been settled by the buyer. However, other than the share price, the buyer will also have to pay an additional (adjustment) amount, which is calculated based on the profit/loss of the issuer at the end of the accounting period.

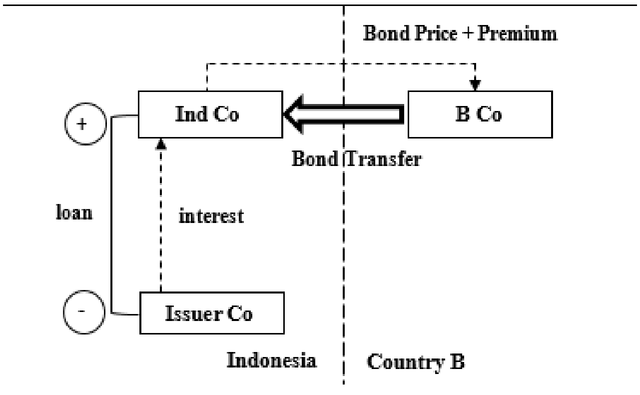

Fig. 4. Bond Transfer with Premium

TABLE III. TAXABLE INCOME UNDER BOND TRANSFER WITH PREMIUM

	Ind Co		B Co		Issuer Co	
	Interest coupon	1,2	Interest coupon	-	Interest coupon	(1,2)
	Bond premium	(0,8)	Bond premium	-		
Net Taxable Income		**0,4**		**-**		**(1,2)**

For buyers, he adjustment can be a deduction. Regarding the seller, the income is treated as income from the sale of asset, which is exempt from tax or fetches certain tax benefit (Example 1.30) [1].

c) Share lending arrangement when dividends are paid to the borrower of shares, but the borrower is required to transfer the dividends to the lender. A mismatch may arise if both of the countries treat the transactions in their legal form, that is, sale and repurchase, such that the dividends will be treated as an adjustment to the repurchase price. Thus, the borrower recognizes a deductible loss on the sale of share, and the lender treats it as a deduction of the (re)purchase price (not as dividends) so that the dividends are not taxed (Example 1.35) [1].

E. Payment Made to a Reverse Hybrid

Based on the interviews, no respondents found that this was scheme used in Indonesia. However, with the current regulation and tax system in Indonesia, this scheme is likely to be used. Figure 5 illustrates the payment received by reverse hybrid. A Co (a resident in country A) wants to lend to C Co. If the loan is given directly, the interest will be taxed in country A. Therefore, A Co lends through B Co (an entity fully owned by A Co). B Co is a reverse hybrid, which is treated as a transparent entity in country B but is treated as a separate taxable entity in country A.

Interests paid by C Co are deductible in Indonesia; however, the interests are not taxable in either country A or B. When B Co receives the interest, country B considers that it should be taxed in country A because the owner, A Co, resides in country A. In contrast, country A considers B Co as a nontransparent entity such that it should be taxed in country B. Therefore, B Co's interest income is not taxable in any way. However, it is assumed that A Co has no taxable presence in country B. If B Co acts as a dependent agent of A Co, country B may impose a tax on such income.

In addition to its position as a payer, Indonesia may also be exposed to the risk of reverse hybrid if it is in the position of the investor country (such as country A in this case), because Indonesia is not familiar with the concept of transparent entities and regards every entity as a separate taxable entity. In addition, Indonesian CFC rules define CFC based on percentage of share, whereas hybrid entities such as LLC in the United States usually do not have a share in their capital structure.

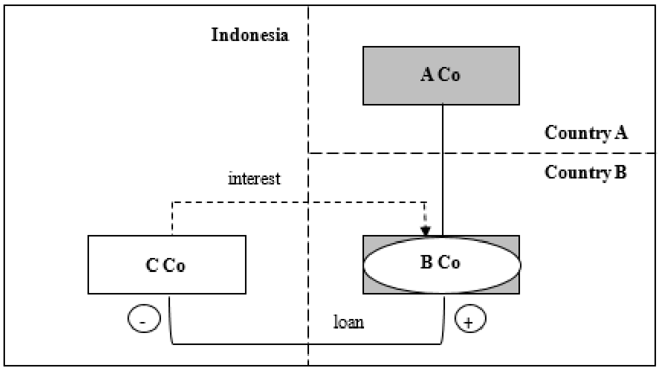

Fig. 5. Payment Made to a Reverse Hybrid

In addition to raising the D/NI outcome, the use of tax treaty in determining the taxing rights is another issue regarding payments made to reverse hybrid. In this case, Indonesia may lose its taxing rights if its resident is wrong in applying tax treaty for the purpose of withholding tax. It can occur if by using the tax treaty between Indonesia and country B, Indonesia is losing the right to taxation, which should be obtained from the tax treaty between Indonesia and country A. However, it can be overcome by requiring Certificate of Domicile (COD) to implement tax treaties as stipulated in Director General of Taxes Regulation Number PER-10/PJ/2017 about Procedures for Applying Tax Treaty.

V. ANALYSIS AND DISCUSSION

Based on in-depth interviews with key respondents, the practice of tax avoidance using hybrid mismatch arrangements in Indonesia is still limited. This is contrary to the preliminary investigations conducted by the United Nations [2] and the research conducted by [3] which includes hybrid mismatch arrangements as vital to developing countries. The limited number of tax avoidance using hybrid mismatch arrangement schemes in Indonesia is attributed to the following factors:

a) There are other alternatives to achieve the same outcome

To achieve the same outcome with hybrid mismatch arrangements, taxpayers may use other simpler means such as by transacting with countries having certain tax facilities, for example, the Netherlands and Hong Kong. Hong Kong has a territorial tax system such that income received from outside is not taxed [23], while the Netherlands is a "treaty haven" country [24]. The tax rate on interest income for a loan with a maturity of more than 2 years in a tax treaty between Indonesia and the Netherlands is 0%, and the Netherlands tax treaties rate with its partner countries is mostly 0% [23]. Although in the amendment effective from October 1, 2017, the rate of interest changed to 5%, it is still low compared to the rate with other partner countries, which averaged 10%.

Tax haven utilization can also produce the same effect as with a hybrid arrangement [10]. However, the use of hybrid arrangement can help multinational companies to reduce their effective tax rate even though they operate in a high tax jurisdiction [16].

b) Some hybrid mismatch arrangement schemes are not effective for use in Indonesia

Some schemes of hybrid mismatch arrangements are not feasible or are ineffective for use in the Indonesian taxation systems. These ineffective schemes include the following:

(1) Hybrid Financial Instruments with Indonesian Taxpayer as payee

In relation to the taxation system of the corporation and its shareholders, Indonesia applies the classical tax system. This means that the income earned by a corporation is taxed at the corporate level as well as at the shareholder level (when dividends are distributed to shareholders). In addition, Indonesia does not exempt/exclude foreign dividend and capital gain from tax. Therefore, all foreign income should be included in ordinary income, and the tax relief (ordinary credit method) is only given for withholding tax imposed by the source country.

(2) Dual Resident Entity

In schemes involving a dual residence entity, these can create DD outcome when both the countries, where the entity becomes resident, have a consolidation tax regime. This regime permits corporate groups to be regarded as a single economic unit for tax purpose and allows offset of profits and losses within the group [9]. When the dual resident entity suffers a loss, the loss can reduce the taxable income of its affiliated companies in two different countries, resulting in a DD outcome. In addition, Indonesia is not familiar with the concept of disregarded entity whose profit can be offset by the loss of dual resident entity. Thus, dual resident entity is not effective for use in Indonesia.

(3) Hybrid/Disregarded Entities

Based on the analysis of various schemes or structures used to produce the DD outcome or deduction/no inclusion (D/NI) outcome in various literatures and examples in Action 2: 2015 Final Report, this study concludes that Indonesia is not exposed to risk due to the use of hybrid/ disregarded entity for the following reasons:

(a) As the country where the parent company or head office is located:

i. Indonesia is not familiar with the concept of transparent entity such that the payment paid by foreign subsidiaries cannot be deducted from domestic income.

ii. Indonesia does not allow losses suffered by foreign branches to be deducted from the income of the head office; only profits derived from foreign branches will be included in the income tax calculation in Indonesia.

(b) As the country where the subsidiary or branch is located:

i. Indonesia does not recognize the consolidation tax regime because the tax is calculated by each business entity even though it is within the same control group (related parties). Accordingly, if any business entity incurs a loss, the loss cannot be offset against the income derived by the other entities.

ii. Indonesia does not recognize the concept of disregarded or transparent entity. A set of persons and/or capital constituting a unit, including partnership, is subject to tax as a taxable entity, which is subject to a separate tax from its owner.

c) The schemes are not realized or cannot be identified by the tax authority

In the case of imported mismatches, it can be in the form of an ordinary loan. Although ordinary loan is the instrument used by a taxpayer, Indonesia is also affected by base erosion caused by hybrid mismatch arrangements generated in other countries. This mismatch will not be detected unless the tax authority performs an in-depth tax audit for other transactions, especially transactions in one control group so that the tax authority can see the whole picture of the transactions. In addition, the tax authority should perform Exchange of Information (EOI) with other countries.

Indonesia currently has the arm’s-length principle in Article 18 paragraph (3) of the Income Tax Law, which can reclassify debt into equity in case of related parties. However, the determination of such classification does not consider the tax treatment in counterpart jurisdiction. Therefore, the tax authority does not pay attention to the tax treatment in counterpart jurisdiction and cannot assess or identify the number and the risk of hybrid mismatch arrangements to Indonesian tax base. Therefore, socialization and training on hybrid mismatch arrangement schemes are required for tax officers, such that they can identify hybrid mismatch arrangement schemes that are generally or may be used by Indonesian taxpayers.

VI. CONCLUSION

Based on the research, it can be concluded that the most typically used scheme in Indonesia is the debt/equity hybrid (financial instrument) by involving Indonesian corporations as the payer. Moreover, hybrid transfer and imported mismatch schemes are also used in Indonesia. Although substitute payment and payment made to reverse hybrid schemes have not been found, these schemes are likely to be used in Indonesia under the current regulations and the taxation system.

In general, the habit of tax avoidance using hybrid mismatch arrangement schemes in Indonesia is still lacking because of factors such as

1. There are other alternatives to achieve the same outcome;

2. Some hybrid mismatch arrangement schemes are not effective for use in Indonesia; and

3. The schemes are not realized or cannot be identified by the tax authority.

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