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Hybrid Mismatches After the ATAD

Theoretical Aspects of International Cooperation in Tax Matters

Dissertation

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List of Abbreviations

ACE	Allowance for Corporate Equity
ATAD	Anti-Tax Avoidance Directive
BEAT	Base Erosion and Anti-Abuse Tax
BEPS	Base Erosion Profit Shifting
BRICS	Brazil Russia India China South Africa
CARICOM	Caribbean Tax Treaty Networks
CBIT	Comprehensive Business Income Tax
CCTB	Common Corporate Tax Base
CCCTB	Common Consolidated Corporate Tax Base
CEN	Capital Export Neutrality
CFC	Controlled Foreign Company
CFT	Cash-Flow Tax
CIN	Capital Import Neutrality
CIT	Corporate Income Tax
CITA	Czech Income Tax Act
CON	Capital Ownership Neutrality
CRS	Common Reporting Standard
DAC	Directive on Administrative Cooperation
DD	Double Deduction
D/E	Debt-Equity
D/NI	Deduction Without Inclusion
DTC	Double Tax Convention
EU	European Union
FATCA	Foreign Account Tax Compliance Act
GAAR	General Anti-Avoidance Rule
GILTI	Global Intangible Low Tax Income
G20	Group of Twenty
HFI	Hybrid Financial Instrument
IBFD	International Bureau of Fiscal Documentation
ICC	International Chamber of Commerce
ICJ	International Court of Justice
IRC	Internal Revenue Code

IRD	Interest-Royalty Directive
MLI	Multi-Lateral Instrument
MN	Market Neutrality
MTC	Model Tax Convention
NID	Notional Interest Deduction
NN	National Neutrality
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
PCIJ	Permanent Court of International Justice
PSD	Parent-Subsidiary Directive
SAAR	Specific Anti-Avoidance Rule
SPV	Special Purpose Vehicle
TEU	Treaty on European Union
TFEU	Treaty on Functioning of European Union
TIEA	Tax Information Exchange Agreement
T.Reg	United States Treasury Regulation
UN	United Nations
US	United States
VCLT	Vienna Convention on Law of Treaties

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[1] Jericho Coffee Traders in Oxford, the UK, is also highly recommendable.

1. Introduction

1.1. What Is This Dissertation About?

This dissertation[2] has one leading argument, *i.e.* the current approach toward hybrid mismatches using linking rules[3] has many shortcomings and thus EU Member States should consider and adopt other solutions to hybrid mismatches, in particular coordination rules,[4] to achieve single taxation of cross-border income if it is their tax policy goal.[5] To pursue this argument, I show what hybrid mismatches are, what outcomes hybrid mismatches have, what is the tax policy debate behind these outcomes, *i.e.* why these outcomes matter to countries or not, what is the current mainstream solution to hybrid mismatches, *i.e.* linking rules, why linking rules are ineffective, and why I and other scholars think that coordination rules are a better solution to the hybrid entities, hybrid financial instruments, and hybrid transfers issue while acknowledging limitations of coordination rules. Finally, I argue that EU Member States can still use coordination rules to deal with hybrid mismatches even under the ATAD.

The discussion touches many essential questions and problems of international taxation, *e.g.* how countries should design their international taxation, fiscal transparency of legal entities, what is the underlying approach of countries in the international tax arena—cooperation or competition—, the debt-equity conundrum in income taxation, and, in particular, how many times and how much should countries tax a cross-border income. Therefore, besides supporting my leading argument, I show in this dissertation that the BEPS Project Action 2 linking rules tax policy goal is not *substantial* single taxation *where value is created* but *formal* single taxation *no matter where*.[6] This

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[2] This dissertation was elaborated with financial support and within the project "*International Cooperation in Tax Administration in the Context of European and International Law*" of the Grant Agency of the Charles University No. 798217/2017, which was realized in the years 2017, 2018, and 2019 at the Faculty of Law of the Charles University, Prague, the Czech Republic.

[3] The term *linking rules* expresses that "*tax treatment of an entity, instrument, or transfer would "linked" to another country's tax treatment of the same entity, instrument, or transfer*". ATHANASIOU, Amanda. Hybrid Mismatch Proposals: Practical Problems Remain. *Tax Notes International*. 2014, 2014(June 23, 2014), p. 1083.

[4] Thuronyi defines coordination rules as "*rules for coordinating how their domestic rules apply to cross-border transactions*" and explains that coordination rules are "*similar to the choice-of-law rules that apply in the private international law area (sometimes called conflict of laws)*". THURONYI, Victor. Coordination Rules as a Solution to Tax Arbitrage. *Tax Notes International*. 2010, 2010(March 22), p. 1053-1054. For a discussion on how to use coordination rules to deal with tax arbitrage, see *ibid*, p. 1053-1060.

[5] Hybrid mismatches can lead to non-taxation as well as multiple taxation outcomes in cross-border transactions. The non-taxation is an outcome of a combination of deduction(s) and/or exemption(s). Current linking rules deal with this by denying deduction or exemption when hybrid mismatch leads to non-taxation but do not change tax characterization of particular entity, financial instrument or ownership. Coordination rules aim to prevent both, non-taxation and double taxation, by aligning the tax characterization of particular entity, financial instrument or ownership. See below for a detailed discussion.

[6] Formal single taxation denotes situations where countries tax cross-border income *exactly* once, *i.e.* countries raises only one levy. Substantial single taxation denotes situations where countries tax cross-border income *enough* in accordance with some underlying normative assessment of what enough means. See below for a detailed discussion.

applies also to the EU because ATAD's linking rules have the same tax policy goal, *i.e.* to achieve *formal* single taxation, preferably somewhere in the EU.[7] This is essential for the application of linking rules in domestic law because if a taxpayer achieves low *formal* single taxation by using a hybrid mismatch, tax administrators cannot consider such a situation as a downright avoidance of linking rules. This is important because countries might consider in the future that they actually want to achieve *substantial* single taxation instead of *formal* single taxation and that they perceive *deduction/low-taxation* as an unwanted outcome. Regarding the normative assessment of double non-taxation, single taxation, and multiple taxation, I conclude that the discussion has been persisting but without a definite universal conclusion about the existence of the single tax principle as an actual tax policy goal or legal principle. From the tax policy perspective so far, it seems that countries themselves accept or deliberately pursue all range of outcomes, *i.e.* (double) non-taxation, *formal* single taxation, or *substantial* single taxation situations based on their tax policy aim and generally try to prevent juridical double taxation, but they prevent double economic taxation only in some cases. From the legal perspective, the single tax principle is a murky concept that may appear as a legal principle in some tax law areas but has not become part of public international customary law yet. Thus, EU Member States must achieve only *formal* single taxation in hybrid mismatches scenarios under the ATAD and the PSD. However, if EU Member States want to pursue *substantial* single taxation instead of *formal* single taxation, they should deal also with *deduction/low-taxation* outcomes and ideally use coordination rules instead of linking rules or ought to consider enacting a condition asking for *substantial* taxation of the income under hybrid mismatch.

Some countries' practices and Parada's work[8] have shown that it is possible to use coordination rules to deal with hybrid entities. Some countries and authors have also dealt with coordination rules in relation to debt-equity hybrid financial instruments.[9] And I want to show it is possible to do the same with hybrid transfers. Next, I will discuss the use of coordination rules to tackle hybrid mismatches effectively in the post-ATAD's world while avoiding EU law infringement and fostering EU values of non-discrimination using the *mutual recognition principle*. I believe this

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[7] I do not deal with linking rules of countries beyond the EU area; however, the U.S. has adopted the same approach by enacting the OECD BEPS Action 2 linking rules and thus the IRC also pursues *formal* single taxation instead of *substantial* single taxation in hybrid mismatch arrangements. See in general about the US adopting the linking rules *e.g.* BODOH, Devon, Greg FEATHERMAN, Alfonso DULCEY, Lukas KUTILEK and Charlie ROARTY. Anti-Hybrid Rules: The IRS Issues Final & Proposed Regulations. Weil Tax Blog [online]. New York: Weil, Gotshal & Manges, 2020, April 9, 2020 [cit. 2020-08-17]. Available at: https://tax.weil.com/features/anti-hybrid-rules-the-irs-issues-final-proposed-regulations/. ; FULLER, James P. and Larissa NEUMANN. U.S. Tax Review. *Tax Notes International*. 2020, 2020(May 4, 2020), p. 511-527. ; HELLKAMP, Lori and Alden DIIANNI-MORTON. It's Time to Look Again at the Anti-Hybrid Rules. *Tax Notes Federal*. 2020, 2020(June 22, 2020), p. 2045-2049.

[8] PARADA, Leopoldo. Double non-taxation and the use of hybrid entities: an alternative approach in the new era of BEPS. Alphen aan den Rijn, The Netherlands: Kluwer Law International, B.V, 2018, p. 353-397. ISBN 978-90-411-9991-1.

[9] See below.

solution is more effective than OECD's/ATAD's *linking rules* because linking rules do not tackle core issues of hybrid mismatches but lead to further complexity in tax administration and tax planning.

1.2. How Did We Get Here? A Brief Summary of Long History

It has been seven years since the G20 and the OECD started the anti-BEPS project[10] in 2013 which came as the aftermath of the financial crisis of 2008 and the subsequent struggle of governments to raise tax revenues and deal with revelations of various tax avoidance and tax evasion schemes in media.[11] The overall BEPS Project mission is "*to align the location of taxable profits with the location of economic activities and value creation*".[12] Tax policymakers consider the BEPS Project a fundamental change to the international taxation arena and, in particular, to tax planning, as we know it.[13] The OECD BEPS Project consists of fifteen actions that have led to fifteen action final reports that contain tax policy recommendations for countries to tackle tax avoidance of allegedly[14] enormous proportions.[15] Moreover, the main players of the international tax arena have started

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[10] For information about the BEPS Project and its actions see e.g. BEPS Actions. *OECD BEPS* [online]. Paris: Organisation for Economic Co-operation and Development, © 2019 [cit. 2020-07-08]. Available at: https://www.oecd.org/tax/beps/beps-actions/.

[11] See *e.g.* FUNG, Sissie. Erasmus Law Review: The Questionable Legitimacy of the OECD/G20 BEPS Project [online]. Eleven international publishing, 2017 [cit. 2020-07-08]. DOI: 10.5553/ELR.000085. ISSN 2210-2671. Available at: http://www.elevenjournals.com/doi/10.5553/ELR.000085. ; GOVIND, Sriram and Stephanie ZOLLES, Chapter 8 – The Anti-Tax Avoidance Directive. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 218. ; EUROPEAN PARLIAMENT. Bringing transparency, coordination and convergence to corporate tax policies. European Parliament [online]. Strasbourg: European Parliament, 2015 [cit. 2020-08-17]. Available at: https://www.europarl.europa.eu/doceo/document/TA-8-2015-0457_EN.pdf. ; WELLS, Bret and Cym H. LOWELL. Income Tax Treaty Policy in the 21st Century: Residence vs. Source. *Columbia Journal of Tax Law.* 2014, 5(1), p. 3-4. ISSN 2169-4680. ; PARADA, Leopoldo, ref. n. 8, p. 13-14. ; HERZFELD, Mindy. The Case against BEPS: Lessons for Tax Coordination. *Florida Tax Review.* 2017, 21(1), p. 4-5. ; BRAUNER, Yariv. BEPS: An Interim Evaluation. *World Tax Journal.* 2014, 6(1), p. 10-11.

[12] AVI-YONAH, Reuven S. and Haiyan XU. EVALUATING BEPS: A RECONSIDERATION OF THE BENEFITS PRINCIPLE AND PROPOSAL FOR UN OVERSIGHT. *Harvard Business Law Review.* Cambridge, 2017, 6(2), p. 207. However, this proclamation was heavily criticized and scholars are skeptical about this principle, its execution, and validity. See *e.g.* HERZFELD, Mindy, ref. n. 11, p. 1-59. ; KYSAR, Rebecca M. Value Creation: A Dimming Lodestar for International Taxation. *Bulletin for International Taxation.* 2020, 74(4/5), p. 216-221. Kysar concludes that "*Value creation ultimately doubles down on the concept of source, which has always been economically empty but has become even more meaningless in a global and digital economy*". See *ibid*, p. 220.

[13] See *e.g.* the comment of the OECD Secretary-General Angel Gurriat in OECD presents outputs of OECD/G20 BEPS Project for discussion at G20 Finance Ministers meeting. *Organisation for Economic Co-operation and Development* [online]. Paris: Organisation for Economic Co-operation and Development, © 2020 [cit. 2020-07-15]. Available at: https://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm.

[14] See *e.g. ibid* or OECD. Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project. OECD [online]. Paris: Organisation for Economic Co-operation and Development, 2015, p. 4, par. 2 [cit. 2020-08-17]. Available at: https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf.

[15] For all final reports from 2015 see *e.g.* BEPS 2015 Final Reports. OECD [online]. Paris: Organisation for Economic Co-operation and Development, 2019 [cit. 2020-07-08]. Available at: http://www.oecd.org/tax/beps-2015-final-reports.htm.

implementing the BEPS actions, *e.g.* the EU by the ATAD, surprisingly the U.S. by the Tax Cuts and Jobs Act[16] and subsequent Treasury regulations[17], and China[18].[19]

In regard to hybrid mismatches, the most influential BEPS Action is the Action 2 - Neutralising the Effects of Hybrid Mismatch Arrangements.[20] In the EU context, the Anti-Tax Avoidance Directive has implemented the anti-hybrid mismatches provisions that stemmed from the Action 2 into EU law as the minimum standard[21] for EU Member States. The Council of the EU had firstly implemented the Action 2 by the ATAD I[22] which had used linking rules to deal only with hybrid mismatches between EU Member States.[23] Later on, the Council passed an amendment to the ATAD I, the ATAD II[24], which has broadened the scope of the ATAD[25] in order to deal with hybrid mismatches arising between both, EU Member States and non-EU Member States, *i.e.* so-called third countries.[26]

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[16] AVI-YONAH, Reuven S. The Triumph of BEPS: US Tax Reform and the Single Tax Principle. *University of Michigan Public Law and Legal Theory Research Paper Series ; Law & Economics Research Paper Series*. 2017, 2017(579 ; 17-021), p. 1-8.

[17] Rules Regarding Certain Hybrid Arrangements. *Federal Register* [online]. Washington, DC: The Office of the Federal Register (OFR) of the National Archives and Records Administration (NARA), and the U.S. Government Publishing Office (GPO), 2020 [cit. 2020-07-15]. Available at: https://www.federalregister.gov/documents/2020/04/08/2020-05924/rules-regarding-certain-hybrid-arrangements.

[18] See *e.g.* AVI-YONAH, Reuven S. and Haiyan XU. China and BEPS. *Laws*. 2018, 7(4), p. 1-26. DOI: doi:10.3390/laws7010004. ISSN 2075-471X. ; ZHUANG, Wei. BEPS Implementation in China: Review and Outlook. *Tax Notes International*. 2019, 2019(August 19, 2019), p. 723-732. However, the reaction of BRICS countries and other source countries, to the BEPS Project was not only welcoming. See *e.g.* WELLS, Bret and Cym H. LOWELL, ref. n. 11, p. 4-5.

[19] For a general and recent discussion on the implementation of hybrid mismatch rules, see BRABAZON, Mark. Are We There Yet? International Implementation of Hybrid Mismatch Rules. *Bulletin for International Taxation*. 2019, 73(6/7), p. 304-315.

[20] See the final report from 2015 *e.g.* OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241138-en.

[21] See Article 3 of the ATAD.

[22] 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.

[23] Article 2(9) and article 9 of the ATAD I.

[24] COUNCIL DIRECTIVE (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

[25] See Article 2 and 9, 9a and 9b of the ATAD. I use the terms the ATAD I and the ATAD II in instances when I refer specifically to one of these two directives and I use the ATAD in cases when I refer to the currently effective (consolidated) version of the ATAD. For the non-binding consolidated version of the ATAD missing Article 9a of the ATAD, see EUR-Lex - 02016L1164-20200101 - EN - EUR-Lex: Consolidated text: 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. *EUR-Lex* [online]. Luxembourg: EU Publications Office, 2020 [cit. 2020-07-27]. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02016L1164-20200101.

[26] For a brief summary of the process see *e.g.* WHERE DO WE GO FROM HERE? THE STEADY MOVE TOWARDS A COMMON CORPORATE TAX BASE. HASLEHNER, Werner, Katerina PANTAZATOU and Alexander RUST. *A Guide to the Anti-Tax Avoidance Directive*. Edward Elgar Publishing, 2020, p. 305-306. DOI: https://doi.org/10.4337/9781789905779.00021. ISBN 9781789905779.

Much has happened since the OECD BEPS Action 2 and the enactment of the ATAD. EU Member States have been implementing the ATAD's anti-hybrid mismatches provisions[27] and scholars have thoroughly analyzed the OECD BEPS Action 2 outcomes as well as the ATAD.[28] The main outcome of this analysis was a substantial critique of both. Scholars have criticized the OECD BEPS Action 2 report on the grounds that it recommends the application of linking rules which try to connect hybrid mismatches with their outcomes[29], principally double non-taxation in the forms of (i) double deduction with only single inclusion of an income stemming from this deduction (DD outcome) and (ii) deduction without a corresponding inclusion of an income stemming from such deduction (D/NI outcome).[30] Thus, the Action presumably fosters the benefits principle[31] and the single tax principle, which as some argue is an underlying principle of the whole OECD BEPS Project.[32] But in fact, linking rules lead only to *formal* single "*taxation no matter where*"[33]. Besides that, scholars have criticized the ATAD for using linking rules instead of other means to tackle hybrid mismatches, hence raising the complexity of the tax system and tax administration[34], as well as for being too broad in scope and thus automatically presuming tax non-compliance[35] in the case of double non-taxation outcomes caused by the hybrid mismatches.[36] On top of that, some authors consider the ATAD and linking rules to be a violation of EU primary law.[37] Also, scholars have started arguing in favor of alternative solutions to deal with the core issue of hybrid mismatches, especially coordination rules.

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[27] National transposition measures communicated by the Member States concerning: 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. *Eur-Lex* [online]. Luxembourg: The Publications Office of the European Union, 2020 [cit. 2020-07-15]. Available at: https://eur-lex.europa.eu/legal-content/EN/NIM/?uri=CELEX:32016L1164.

[28] See *e.g.* PISTONE, Pasquale and Dennis WEBER, ed. *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study*. Amsterdam: IBFD, 2018. ISBN 978-90-8722-446-2.

[29] PARADA, Leopoldo. Hybrid Entity Mismatches and the International Trend of Matching Tax Outcomes: A Critical Approach. *Intertax*. Wolters Kluwer, 2018, 46(12), p. 972-993. Available at SSRN: https://ssrn.com/abstract=3384555.

[30] For a detailed discussion see Chapters 3 and 5.

[31] Avi-Yonah and Xu summarize the benefits principle formed in 1923 stating that "*Under the benefits principle, active (business) income is taxed primarily at source, while passive (investment) income is taxed primarily at residence.*" See AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 12, p. 188. See also Avi-Yonah, ref. n. 115, p. 9.

[32] Besides the benefits principle and the single tax principle, AVI-Yonah and Xu argue that the BEPS Project fosters the anti-discrimination principle and the transparency principle. For the full statement see AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 12, p. 207.

[33] See *e.g.* PARADA, Leopoldo, ref. n. 29, p. 972. ; LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 258, 268-271. Nevertheless, this claim applies only to the OECD's linking rules until all countries adopt linking rules, which may never happen, and ultimately does not apply for the EU area.

[34] See PARADA, Leopoldo, ref. n. 29, p. 972-993.

[35] See DE BROE, Luc. At last, some output on the fight against double non-taxation. *EC Tax Review*. Wolters Kluwer, 2014, 23(6), 311-312. ISSN 0928-2750. ; HJI PANAYI, Christiana. *Advanced Issues in International and European Tax Law*. Hart Publishing, 2015, p. 206. ISBN 9781849466950. as cited in LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 121.

[36] See *e.g.* NAVARRO, Aitor, Leopoldo PARADA and Paloma SCHWARZ. The Proposal for an EU-Anti Avoidance Directive: Some Preliminary Thoughts. *EC Tax Review*. 2016, 25(3), p. 24. Available at SSRN: https://ssrn.com/abstract=2816624.

[37] See *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 325. ; PARADA, Leopoldo, ref. n. 8, p. 329-344.

Therefore, one might start to ask whether there is an alternative for an EU Member State that would like to deal with the hybrid mismatches in a better[38] way or not. And, if there is such an alternative, is it possible to implement it even though the OECD BEPS Project Action 2 and, consequently, the ATAD, took an apparently wrong turn?

Luckily, other scholars have already been asking the first part of the question[39] so I did not have to start from scratch. As I wrote above and show further, prominent scholars have taken the opportunity to analyze hybrid mismatches and the rules dealing with them. Some of these scholars have also considered the ATAD's anti-hybrid mismatches provisions and have come up with proposals for alternative solutions. The ATAD does not contain the obvious solution to deal with hybrid mismatches regarding hybrid entities and hybrid financial instruments, *i.e.* harmonization of definitions of essential tax terms such as taxpayer, interest, dividend, ownership, and permanent establishment.[40] Since harmonization of these definitions is still difficult to achieve in practice, another solution is using coordination rules as used by the Czech Republic, suggested by the European Parliament, proposed by the European Commission, and further discussed by Parada in his work. Similarly, other authors, *e.g.* Helminen[41], Bärsch[42], Bundgaard[43], and Laguna[44], to name a few, have discussed hybrid financial instruments and analyzed the rules that countries use to deal with the debt-equity conundrum. Their ideas, along with my experience from the time when I was working on the ATAD's implementation, lead me to pose the question: *Is it still possible to use coordination rules to deal with hybrid mismatches primarily and enact linking rules only in a case that there is no corresponding coordination rule or such rule is ineffective?*[45]

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[38] In the end, I am not convinced that coordination rules are the ultimate solution to hybrid mismatches. So far it seems to me that a better option is a solution using a formulary apportionment to establish a tax base and proper harmonization rules enacting this apportionment. Such discussion, however, exceeds the scope of my argument in this dissertation, because the formulary apportionment solution seemed too theoretical during the course of my Ph.D. studies. I would like to address solving hybrid mismatches by the formulary apportionment in some of my subsequent works.

[39] See *e.g.* PARADA, Leopoldo, ref. n. 8, p. 353-397.

[40] In the case of PE mismatches.

[41] HELMINEN, Marjaana. *The International Tax Law Concept of Dividend: Second Edition*. Kluwer Law Intl. Alphen aan den Rijn: Wolters Kluwer, 2017. ISBN 978-9041183941.

[42] BÄRSCH, Sven-Eric. *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform*. Berlin Heidelberg: Springer, © 2012. ISBN 978-3-642-32457-4.

[43] BUNDGAARD, Jakob. *Hybrid Financial Instruments in International Tax Law*. Alphen aan den Rijn: Kluwer Law Intl, 2017. ISBN 978-9041182739.

[44] LAGUNA, Félix Daniel Martínez. *Hybrid Financial Instruments, Double Non-taxation and Linking Rules*. Alphen aan den Rijn: Kluwer Law Intl, 2019. ISBN 9789403510743.

[45] Still, I believe that this discussion is of an interim character because the adoption of the formulary apportionment could be a better tax policy option. However, that solution is only nascent.

1.3. Why Does Dealing with Hybrid Mismatches Matter to Society and to Me?

The 2008 financial crisis led to budgetary issues in many countries. Their search for lost tax revenues[46] and work of investigative journalists[47] have brought to the spotlight means how MNEs shift their incomes so they do not have to pay taxes.[48] This led tax policymakers to disclosing tax avoidance schemes and identifying ways how to prevent such transactions which includes using hybrid mismatches.

Hybrid mismatches are mismatches between tax classifications (characterization) of certain aspects of two or more countries (jurisdictions), *e.g.* whether a legal entity is taxable, whether a particular payment is an interest or a dividend, and who is an owner of an asset and thus entitled to tax benefits.[49] The existence of these mismatches is generally not an outcome of malice but an outcome of countries exercising their tax sovereignty, mainly in an uncoordinated manner.[50]

A model example of a hybrid mismatch situation is an arrangement using debt-equity hybrid financial instruments.[51] Countries may categorize differently financial instruments which contain provisions attributable to debt as well as equity. For example, a payer country can categorize the instrument as representing a debt claim, whereas a payee country categorizes the instrument as representing equity. Thus, the payer country considers the payment stemming from the hybrid financial instrument as an interest payment, while the payee country considers the payment a dividend payment. This situation can lead to double non-taxation because the payer country can allow an interest deduction from the payer's tax base and the payee country can exempt such income from the payee's tax base to prevent double economic taxation (see Figure 1).

[46] Corporate income taxes are especially important for developing countries. However, CIT revenues are notable also for the OECD countries. For statistics dealing with importance of corporate income tax to tax revenues see Corporate Tax Statistics: Second Edition. *OECD* [online]. Paris: Organisation for Economic Co-operation and Development, 2020, p. 3-8 [cit. 2020-07-27]. Available at: http://www.oecd.org/tax/tax-policy/corporate-tax-statistics-second-edition.pdf.

[47] For the impact of Panama Papers on the EU tax policy see *e.g.* REPLIES TO THE WRITTEN QUESTIONS PUT FORWARD TO PRESIDENT JUNCKER BY THE "PANAMA PAPERS" COMMITTEE OF INQUIRY. *European Parliament* [online]. Brussels: European Parliament, p. 2-6. [cit. 2020-07-27]. Available at: https://www.europarl.europa.eu/cmsdata/121328/Answers%20Pdt%20Juncker%20to%20PANA.pdf.

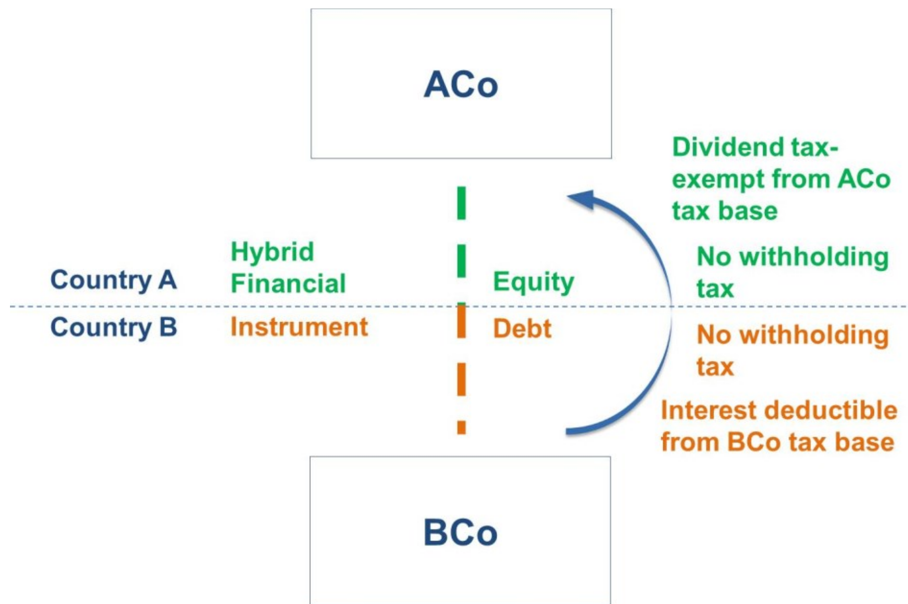
[48] For estimate of effective difference in taxation of MNEs and non-MNEs firms see OECD. *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*. Paris: Organisation for Economic Co-operation and Development, 2015, p. 52-60. ISBN 978-92-64-24134-3. Available at: https://www.oecd-ilibrary.org/docserver/9789264241343-en.pdf?expires=1595851586&id=id&accname=guest&checksum=8EE8B8A9AB9866A6712C20C0F3CE50CC.

[49] For a detailed discussion of hybrid mismatches and relevant sources see Chapter 3.

[50] See *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 235.

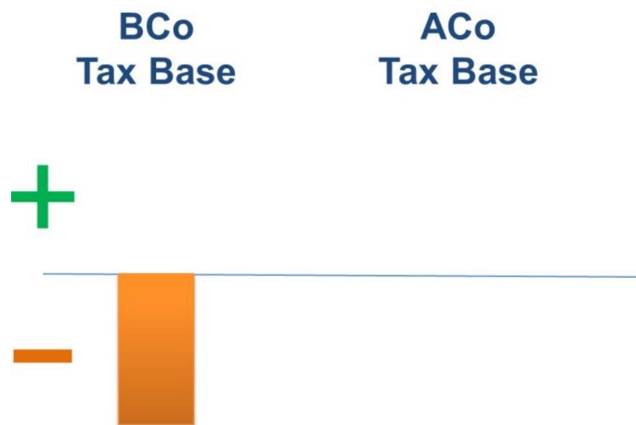
[51] For similar discussion see LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 1-3.

Figure 1 *Debt-Equity Hybrid Financial Instrument Model Example*



This outcome lowers the overall tax duty of the taxpayers involved in a way that would not happen in the domestic situation (see Figure 2).[52]

Figure 2 *Impact on Worldwide Tax Base of ACo And BCo Group*



However, such a mismatch in classification can also lead to a different outcome, *i.e.* not allowing a deduction to an income that the payer's country classifies as a dividend (and therefore should be tax-exempt) but that the payee's country classified as an interest income. A vital aspect of these situations is that these outcomes would not have occurred if the transaction were purely domestic. Taxpayers who can achieve double non-taxation in cross-border settings get, among other things, a competitive advantage against their purely domestic competitors by lowering their tax

[52] Taxes are just another cost (expense) for firms; therefore they try to lower their tax duty as much as they can. See *e.g.* WELLS, Bret and Cym H. LOWELL, ref. n. 11, p. 4. ; SCHÖN, Wolfgang. Tax and Corporate Governance: A Legal Approach. SCHÖN, Wolfgang. *Tax and Corporate Governance*. Berlin, Heidelberg: Springer Berlin Heidelberg, 2008, p. 31-61. MPI Studies on Intellectual Property, Competition and Tax Law. DOI: 10.1007/978-3-540-77276-7_4. ISBN 978-3-540-77275-0. Available at: http://link.springer.com/10.1007/978-3-540-77276-7_4.

burden, which some consider unfair. Besides the competitive issue, taxpayers thus also lower the government's income, which may or may not be in the interest of citizens. From this perspective, the double non-taxation seems like an unwanted outcome. Nonetheless, from the international point of view, the hybrid mismatch result is a result of countries exercising their tax sovereignty. Therefore, the question is, is double non-taxation an infringement of public international law or EU law? In general, the possible infringement could be to the single tax principle.[53] This principle is the subject of a long and vivid discussion. But so far scholars have concluded that the single tax principle is not a legally binding norm under international customary law. However, achieving single taxation is apparently a tax policy goal—if not a general tax policy goal, then definitely in particular areas, in particular hybrid mismatches arrangements.

Meanwhile, the OECD BEPS Action 2 has become crucial not only to tax policymakers and countries that have decided to implement BEPS actions but also to me. During the time I was working for the Ministry of Finance, the ATAD I and 2 became effective and I was one of three lawyers who transposed the ATAD into the Czech Income Tax Act. Having only a slight previous experience with international taxation, we had to become international taxation experts nearly overnight. The main reason for it is that the ATAD's rules are often far from clear and contain many loopholes, as I have pointed out in my earlier works and I am arguing again in this dissertation. (Of course, every tax act does.) However, we did our best regarding the time and resources we had. We relied heavily on the anti-BEPS actions' reports and various works of literature written by academics and tax professionals, to whom I feel greatly indebted. For a while, we had to assume the roles of tax planners and it became obvious that the ATAD's rules are far from perfect. However, due to time constraints, we were able to enhance only few rules. Interestingly, the EU law sphere appeared to be the most troublesome since we had to fight a notion of gold-plating in every stage of the legislative process. We finally succeeded and the proposal became the act and thus the ATAD has become a part of the Czech Income Tax Act. Nevertheless, for me, it was only the beginning because a seed of interest in international taxation had been planted in me. Thus, after finishing my work on the ATAD, I have decided to look back on it as part of my Ph.D. studies and put to good use what I learned during my work on the transposition of the ATAD.

I have discussed certain issues of ATAD rules, *i.e.* thin capitalization rules, exit tax, CFC rules[54], and the new statutory GAAR[55], elsewhere.[56] The topic I have decided to analyze in greater

[53] Leaving aside bilateral relationships under a particular double tax treaty.

[54] See HRDLICKA, Lukas and Petra SMIRAUSOVA. *CFC Rules in the Czech Republic after the ATAD – First Part.* Dane a finance. 2018, 26(2), p. 31-36. ISSN 1801-6006. ; HRDLICKA, Lukas and Petra SMIRAUSOVA. *CFC Rules in the Czech Republic after the ATAD - Second Part.* Dane a finance. 2018, 26(3), p. 31-37. ISSN 1801-6006.

detail in this dissertation is anti-hybrid mismatches rules. I chose the topic mainly for three reasons. Firstly, hybrid mismatches, as tax law as a whole[57], are fun. You can barely find any other topic in legal research that is connected to so many aspects of law and that seems so incomprehensible on the first sight, but which after a while makes sense and becomes irresistibly gripping. Secondly, scholars and tax practitioners have been discussing hybrid mismatches to a great extent but the policy recommendations are still uncertain; further, hybrid mismatches show nearly all the underlying principles of the international tax arena and international tax policy, making them a fitting topic for exploration in a dissertation form in the international taxation field. Finally, it has become obvious during the implementation process that Czech anti-hybrid rules are by no means flawless so I wanted to contribute toward fixing them.

1.4. Object of the Dissertation

The main goal of the dissertation is to analyze the option of preventing hybrid mismatches using coordination rules. For this purpose, the study considers the following research questions that stem from my leading argument[58]:

1. Why can hybrid mismatches arise? (See Chapter 2.)
2. What are hybrid mismatches? (See Chapter 3.)
3. Why do tax policymakers care about hybrid mismatches? (See Chapters 3 and 4.)
4. What is the tax policy aim of linking rules? (See Chapter 5.)
5. Are linking rules effective in dealing with hybrid mismatches? (See Chapter 5.)
6. Is it possible to design other solutions tackling the core issue of the hybrid mismatches while having the same or a similar tax policy aim? (See Chapter 6.)
7. If there is a better solution to hybrid mismatches, is it possible to implement such solution even though the ATAD uses linking rules for solving hybrid mismatches? (See Chapter 8.)

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[55] HRDLICKA, Lukas and Petra SMIRAUSOVA. *Abuse of Law in Tax Process Code from Viewpoint of Transposition of the ATAD*. Dane a pravo v praxi. 2018, 23(7-8), p. 14-20. ISSN 1211-7293.

[56] For the general discussion see BOHAC, Radim and Lukas HRDLICKA. Implementation of the Anti-Tax Avoidance Directive and Czech Law. *DAUC* [online]. The Czech Republic, 2018, 2018(1), p. 1-23 [cit. 2020-07-16]. ISSN 2533-4484. Available at: https://www.dauc.cz/dokument/?modul=li&cislo=242158.

[57] For a similar opinion about taxes, see *e.g.* MCCAFFERY, Edward. *The Oxford Introductions to U.S. Law: Income Tax Law: Exploring the Capital-labor Divide*. New York: Oxford University Press, 2012, p. 24, 27, 225. ISBN 978-0195376715.

[58] I am not using hypotheses because I have to admit that I am skeptical about using them in legal research that is not empirical; non-empirical research, in particular analytical research, is more about argumentation than about proving something as an indisputable fact (or disputable but with a precise set of limitations). This can look discouraging but to me it is an unavoidable result of the relativity of the legal debate on interpretation, which swings from optimism, *i.e.* it is possible to devise methodology leading mostly to one correct answer about what the law is, to pessimism, *i.e.* it is impossible to infer such methodology and thus both law and legal research are mainly about persuasive argumentation. See *e.g.* VANDEVELDE, Kenneth J. *Thinking Like a Lawyer: An Introduction To Legal Reasoning*. 2nd ed. Boulder, Colorado: Westview Press, 2011, p. 235-288. ISBN 978-0-8133-4464-5. I think the truth rests somewhere in the middle.

1.5. Scope of the Dissertation

To pursue my argument, I deal with hybrid entities, hybrid financial instruments, and hybrid transfers because they either share similar characteristics (mainly outcome, payment, and some form of hybridity) or tax policymakers deal with them together even though they have different characteristics, *i.e.* hybrid financial instruments and hybrid transfers. I have decided to deal with these three sets of hybrid mismatches because other authors have covered the use of coordination rules to deal with hybrid entities and some authors have discussed this option regarding hybrid financial instruments, but there is no thorough discussion on dealing with hybrid transfers. Therefore, I wanted my dissertation to deal with hybrid mismatches comprehensively.

I have decided not to deal with branch (permanent establishment) mismatches, dual residency mismatches, and other forms of cross-border mismatches, *e.g.* timing mismatches. The reason for this decision is that mismatches regarding branches are not *hybrid*[59] and form a specific set of mismatches in international taxation. These mismatches, however, do not stem from their inherent hybridity[60] but from mismatches in a specific set of rules that deal with permanent establishments. Also, the OECD has been working intensely on a solution to issues regarding taxing digital services and consequently the OECD might amend the current notion of permanent establishments in the future.[61] Thus, the whole concept of permanent establishments might change and an outcome of my work in this area would become obsolete shortly.[62] Moreover, the discussion about rules dealing with branches (permanent establishments) would railroad me into writing another book, so I have decided to postpone this endeavor for the future.[63] Similarly, I have decided to omit dual residency issues.[64] The dual residency issue is too specific and differs from hybrid entities, hybrid financial instruments and hybrid transfers substantially. I have not included timing

[59] The OECD BEPS Action 2 does not consider these mismatches to be hybrid but the ATAD does. See Article 2(9)(c), (d) and (f) of the ATAD. ; OECD. *Neutralising the Effects of Branch Mismatch Arrangements, Action 2*. Paris: Organisation for Economic Co-operation and Development, 2017, p. 9-12. ISBN 978-92-64-27879-0.

[60] Some authors dispute the existence of a hybrid element in general, but I argue that the question whether a hybrid element exists is more a matter of a proper definition.

[61] OECD, ref. n. 14, p. 8, par. 17.

[62] See *e.g.* Nexus and the ability to have a significant presence without being liable to tax. OECD. *Addressing the Tax Challenges of the Digital Economy, Action 1 2015 Final Report*. Paris: Organisation for Economic Co-operation and Development, 2015, p. 100-102. ISBN 978-92-64-24104-6. ; New nexus rules. OECD. *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS*. Paris: Organisation for Economic Co-operation and Development, 2019, p. 18-19.

[63] For a brief introduction to PE mismatches see Chapter 3.6. For a thorough discussion about permanent establishments see *e.g.* KOBETSKY, Michael. *INTERNATIONAL TAXATION OF PERMANENT ESTABLISHMENTS: Principles and Policy*. Cambridge: Cambridge University Press, 2011. ISBN 978-0-521-51632-7. For the discussion on avoidance of PE status in relation to the BEPS Project see *e.g.* BETTEN, Rijkele and Monia NAOUM. Permanent Establishments in International Tax Structuring. COTRUT, Madalina. *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures*. Amsterdam: IBFD, 2015, p. 43-68. ISBN 978-90-8722-333-5.

[64] For more on dual residency mismatches see famously ROSENBLOOM, David H. The David R. Tillinghast Lecture International Tax Arbitrage and the "International Tax System." *Tax Law Review*. NYU, 2000, 53(2), p. 137-144.

mismatches and other mismatches into the work because these mismatches are also too specific, and I want to focus on hybrid mismatches covered explicitly by the OECD BEPS Project Action 2 and by the EU ATAD.[65]

Further limits of the dissertation are geographical. Since my work mostly deals with the OECD BEPS Project Action 2 and the EU ATAD's linking rules, I have decided to discuss domestic legislation as generally as possible. However, I use examples of domestic laws dealing with hybrid mismatches and I discuss the Czech transposition of the ATAD´s anti-hybrid mismatches rules because the assessment of this transposition is lacking in the Czech Republic and takeaways from the transposition can illustrate some issues other countries struggle with. On international and supranational levels, I deal with international law as well as EU law. I have decided to limit the discussion of tax treaties to the OECD Tax Model Convention[66] because this model treaty is the most relevant for the EU region, but I understand that this does not apply for the whole EU area[67] and that other model treaties exist.[68]

In the dissertation, I consider common income tax design that taxes interest and does not allow for dividend deduction because these measures are specific to some income tax designs. Accordingly, I excluded the comprehensive business income tax (CBIT)[69] and allowance for corporate equity (ACE),[70] for example, in the form of notional interest deductions (NID),[71] considerations from my dissertation's scope for the reasons of brevity and other authors have

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65 These two initiatives deal with timing mismatches only to a limited extent mainly due to their scope in the case of hybrid financial mismatches.

66 See OECD. *Model Tax Convention on Income and on Capital: Condensed Version 2017*. Paris: Organisation for Economic Co-operation and Development, 2017. ISBN 978-92-64-28794-5. Available at: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page1.

67 See *e.g.* Nordic model. OSTASZEWSKA, Ola and Belema OBUOFORIBO. *Roy Rohatgi on international taxation: Volume 1: Principles*. Third edition. Amsterdam: IBFD, 2018, p. 65-66. ISBN 9789087224943.

68 See *e.g.* the UN Model, the U.S. Model, the ILADT Model. For a brief description, see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 58-61. ; UN. *Model Double Taxation Convention between Developed and Developing Countries: 2017 Update*. New York: United Nations, 2017. ST/ESA/PAD/SER.E/213. Available at: https://www.un.org/esa/ffd//wp-content/uploads/2018/05/MDT_2017.pdf. ; United States Model - Tax Treaty Documents. *IRS* [online]. United States: Internal Revenue Service, 2020 [cit. 2020-07-27]. Available at: https://www.irs.gov/businesses/international-businesses/united-states-model-tax-treaty-documents.

69 De Wilde summarizes the CBIT saying that a "*CBIT taxes EBIT*", *i.e.* earnings before interest and taxes. earnings before interest and taxes. DE WILDE, Maarten Floris. Sharing the Pie: Taxing Multinationals in a Global Market. Amsterdam: IBFD, 2017, p. 399. ISBN 978-90-8722-415-8. The CBIT thus avoids one problem of the current income tax design which taxes interest income (see Chapter 2). For a brief description of the CBIT, see *e.g. ibid*, p. 399-408.

70 ACE is a specific form of an alternative to the general income tax design that allows "*a tax deduction for the opportunity costs of equity capital*". See *e.g.* DE WILDE, Maarten Floris, ref. n. 69, p. 409, 410-440.

71 For the discussion, see *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 52-82. For the reasoning behind allowing dividend deduction see *e.g.* AVI-YONAH, Reuven S. and Amir C. CHECHINSKI. The Case for Dividend Deduction. *Tax Lawyer*. 2011, 65(1), p. 3-14. Also, regarding the NID, Karaianov argues "*that the NID is not regarded as a hybrid instrument by the OECD and the European Union, and its application does not lead to an outcome that may be captured by anti-hybrid mismatch rules*". KARAIANOV, Konstantin. Notional Interest Deduction Regimes in Europe: Through the Prism of ATAD II and Domestic Anti-Hybrid Mismatch Rules. *European Taxation*. 2019, 59(10), p. 479-486.

already dealt with the NID in relation to linking rules. Similarly, I do not consider cash-flow tax (CFT) design of income tax.[72]

Furthermore, to ease the flow of discussion, I consider all examples in this dissertation to comply with transfer pricing rules[73], to be compliant with a GAAR, to be exempt from CFC and similar rules, and without the imposition of withholding tax on payments unless I state otherwise.

1.6. Methodology of the Dissertation

Concerning the methodology[74] I deploy to pursue my argument, I mostly use the analytical (doctrinal) methodology with some support of the normative approach. I have decided to choose the analytical approach because it suits the character of my argument, *i.e.* I want to argue that something is possible or impossible under current law. I use normative discussion mainly when I deal with the question of whether some rules should or should not be enacted. If I use an empirical approach, I use it only by citing the empirical work of others to make the analysis sounder.

Regarding the sources I am using, I follow the common doctrinal approach, *i.e.* to pursue the argument, I use official legal sources (public international law, EU law, and domestic law), non-binding and soft law documents, other official sources discussing tax policy (*e.g.* explanatory memoranda), and works of other scholars and tax professionals.

Since I am writing the dissertation in English, I have decided to use prevalently sources written in English and joining the international discussion on hybrid mismatches. However, I acknowledge that Czech and Slovak scholars have extensively discussed international taxation[75] and

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[72] Under the CFT, any "*inbound payments and outbound payments constitute a taxable event*". See *e.g.* DE WILDE, Maarten Floris, ref. n. 69, p. 440, 441-482.

[73] For the newest development connected to transfer pricing and group financing, including *e.g.* hybrid financing, see WITTENDORFF, Jens. Transfer Pricing Oddity: The OECD's New Guidelines on Financial Transactions. *Tax Notes International*. 2020, 2020(August 10, 2020), p. 723-739.

[74] The whole issue of an existence and use of methodology in legal research would need another book. Therefore, I have decided to use the division among approaches I first heard from Bobek, which seems to me to be the most useful. Bobek divides approaches to legal research in four parts, *i.e.* descriptive, analytic, normative and empirical, and states that description is actually not research at all. I concur. BOBEK, Michal. Research in Law: Between a Nike Commercial and Quantum Physics? *Jurisprudence*. Wolters Kluwer, 2016, 2016(6), p. 4-7. ISSN 1802-3843. For similar methodology approach in tax law see BROOKS, Neil. An Overview. EDGAR, Tim, Arthur COCKFIELD and Martha O'BRIEN, ed. *The Logic, Policy and Politics of Tax Law: 15th Edition*. Carswell, 2015, p. 24-34. ISBN 9780779866953.

[75] For international taxation from the Czech and Slovak perspective see *e.g.* KOTAB, Petr. *International Aspects of Taxation in the Czech Republic*. Prague, 2014. Available at: https://is.cuni.cz/webapps/zzp/download/140039603. Dissertation. Charles University Faculty of Law. ; CACKOVA, Hana. Tax planning through intercompany financing in the post-BEPS era. Brno, 2017. Available at: https://theses.cz/id/3qqsqv/zaverecna_prace.pdf. Diploma thesis. Mendel University. ; SEJKORA, Tomas. *NON BIS IN IDEM IN TAX MATTERS. QUO VADIS*. The Lawyer Quarterly. 2019, 9(1), 47-60. ISSN 1805-840X. ; RADVAN, Michal and Johan SCHWEIGL. Corporate Tax Residence in the Czech Republic. In Edoardo Traversa (ed.). *Corporate Tax Residence and Mobility*. 1. ed. Amsterdam: IBFD, 2018. p. 213-234. EATLP International Tax Series, vol. 16. ISBN 978-90-8722-451-6. ; SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA. *International Income Taxation: Double Tax Treaties and Income Taxation Act*. 4. ed. Prague: Wolters Kluwer, 2017. Dane (Wolters Kluwer CR). ISBN 978-80-7552-688-5. ; Legal Aspects of Tax Administration

related topics, *e.g.* double non-taxation[76], direct tax harmonization in the EU, the ATAD's implementation.[77] Other Czech authors have also briefly discussed hybrid mismatches.[78] Nevertheless, I use Czech sources in the case the issue I discuss concerns the Czech Republic or the Czech source is the most relevant.

1.7. Significance of the Dissertation

The aim of this work is (i) to argue that EU Member States can still use coordination rules to tackle some outcomes of hybrid entities, hybrid financial instruments, and hybrid transfers that countries may perceive as unwanted from their tax policy perspective, (ii) to argue that the use of linking rules shows that the OECD and the EU tax policy aims regarding hybrid mismatch arrangements are rather *formal* single taxation, *i.e.* the income must be taxed *just* once, "*no matter where*" instead of *substantial* single taxation, *i.e.* the income must be taxed *enough*, "*where the value is created*", and (iii) to join others, in particular Thuronyi and Parada, to show that countries can use coordination rules to solve issues connected to hybrid entities, hybrid financial instruments, and hybrid transfers.

My contribution to the field of international taxation is that I (i) add my perspective to the debate about hybrid mismatches and their underlying principles, (ii) illustrate that the G20/OECD BEPS Project and the ATAD's aim in the field of hybrid mismatches is not *substantial* single taxation, which is important if countries use the GAAR or the SAAR to protect avoidance of linking rules, (iv) show that using coordination rules is a feasible and a preferable approach to hybrid mismatches because linking rules have many practical flaws and are easier to tax plan around, especially if the actual state's tax policy is the *substantial* single taxation. (iv) discuss if linking rules could become an international custom, (v) add my perspective on using coordination rules to deal with hybrid entities, hybrid financial instruments, and hybrid transfers, (v) show loopholes and

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Electronisation. In: GABOR, Hulko and Roman VYBIRAL. *Currency, Taxes and Other Institutes of Financial Law in the Year of the 100th Anniversary of the Founding of Czechoslovakia*. Budapest: Dialog Campus, 2019, p. 577-584. DOI: https://doi.org/10.36250/00749.55. ISBN 978-615-6020-42-0. ; RADVAN, Michal and Dana SRAMKOVA. Tax Law Components to Provide Incentives for Investment. In Brown, Karen B. (Ed.). *Taxation and Development – A Comparative Study*. 1st ed. Cham: Springer International Publishing, 2017. p. 107-122. ISBN 978-3-319-42155-1. doi:10.1007/978-3-319-42157-5_6. ; VYBIRAL, Roman. International Cooperation in the Fight against Tax Evasion. *Public Governance, Administration and Finances Law Review in the European Union and Central and Eastern Europe*. 2019, 2019(1), 44-49. ISSN 2498-6275.

[76] For the summary of the Slovak debate on double non-taxation see *e.g.* BABCAK, Vladimir. Thinking about the double non-taxation problem. In: TOMASKOVA, Eva, Damian CZUDEK and Jiri VALDHANS. *DAYS OF LAW 2018*. Brno: Masaryk University, 2019, p. 7-48. ISBN 978-80-210-9327-0.

[77] BOHAC, Radim and Petra SMIRAUSOVA. The explicit introduction of the principle of the prohibition of abuse of rights in the Tax Procedure Code. *DAUC - Expertni prispevky*. 2019, 2019(4), p. 1-8. ISSN 2533-4484.

[78] See *e.g.* RADVAN, Michal, MRKYVKA, Petr et al. *Income Taxes*. Brno: Masaryk University, ©2016, p. 70-74. ISBN 978-80-210-8395-0. ; KNETL, Stepan. *Implementation of ATAD*. Prague, 2018, p. 22-24. Master's Thesis. Charles University Faculty of Law. ; CACKOVA, Hana, ref. n. 75.

omissions of current Czech anti-hybrid mismatches rules, and (vi) argue that EU Member States can use coordination rules to deal with hybrid mismatches under EU law.

1.8. Previous Studies on Hybrid Mismatches and Coordination Rules

The literature on economic and legal rules and principles underlying international taxation is vast. Scholars have dealt profoundly with hybrid mismatches, their economic and legal essence, their possible outcomes, and the rules trying to prevent or at least alleviate their outcomes. Particularly, the hybrid entities and debt/equity hybrid financial instruments have been subject to thorough research. I am using these works to structure my argument, to join the academic discussion, and to push further the discussion in the field. I cite every piece of work I have used in footnotes and bibliography. My work builds especially on the previous works of Avi-Yonah, Bärsch, Bundgaard, Dagan, Helminen, Laguna, Parada, and Thuronyi.

1.9. The Structure of the Dissertation

I have divided the dissertation into seven chapters and the conclusion and summary to support my argument and to answer the research questions.

The goal of Chapter 2 is to show how mismatches in cross-border taxation can appear to establish a baseline for further discussion. To demonstrate that point, I describe the current system of international income taxation in general, *i.e.* what are the elements of the tax system that are relevant to establishing a tax jurisdiction over a cross-border income, where these rules are enacted, what the relationships between these rules are, how these mismatches arise, and how tax policymakers can tackle them. To clarify terms that I use in subsequent chapters, I have also included a brief subchapter on differences between tax theory, tax policy, and tax law.

Chapter 3 deals with hybrid mismatches, their definitions, examples, and outcomes. The objective of the chapter is to show what hybrid mismatches are and what outcomes they can create so I can discuss in the subsequent chapter why hybrid mismatches outcomes are an issue from the tax policy perspective, *i.e.* lead to double non-taxation and double taxation outcomes.

In Chapter 4, I join the great debate on the single tax principle to discuss whether outcomes of hybrid mismatches are an issue or not. I conclude that so far the academic debate has not come to a definite conclusion about the existence or non-existence of the single tax principle; thus, I argue that the question is now rather what is the current tax policy aim of the OECD, the EU, and particular countries and then I explain that current initiatives regarding hybrid mismatches do not support the single tax principle in general, but enforce only the *formal* single tax principle in a particular subset of hybrid mismatches which the OECD calls *hybrid mismatch arrangements*. As I show later, this emphasis on *formal* single taxation might appear to be a loophole in the case that

countries shift their tax policy aim from ensuring *formal* single taxation to establishing the *substantial* single taxation instead. However, even though the discussion is not definite on the normative assessment of double non-taxation, single taxation, and double taxation, the tax policy goal to achieve at least *formal* single taxation in hybrid mismatch arrangements situations is obvious.

In Chapter 5, I show where linking rules come from and that linking rules lead merely to *formal* single taxation "*no matter where*". Then, I argue that linking rules are effective only in achieving *formal* single taxation but their implementation and application bring many ramifications for taxpayers and tax administrators. Therefore, I suggest that tax policymakers and scholars should discuss other solutions to deal with hybrid mismatches while achieving single taxation and that this solution should be congruent with domestic tax situations.

Chapter 6 thus deals with alternative solutions to hybrid mismatches until more viable options are on the table, *e.g.* formulary apportionment of the corporate tax base. Due to the scope of the dissertation and limitations stemming from EU law, I mostly discuss coordination rules. I show that coordination rules can be a better tax policy option than linking rules and that countries should adopt these rules in the case they want to achieve single taxation rather than using the linking rules without compromising the integrity of income tax law.

In Chapter 7, I analyze the Czech transposition of ATAD's linking rules. Firstly, I describe the situation before the transposition. Then, I show what the current state of the transposition is. Lastly, I pinpoint loopholes and parts of the ATAD that have not been transposed yet and how the CITA should be amended to avoid an infringement procedure.

The final chapter argues that it is still possible to use coordination rules to tackle hybrid entities, hybrid financial instruments, and hybrid transfers instead of linking rules under the ATAD.

2. Setting the Scene: Legal Systems and Their Interactions in International Taxation

2.1. Introduction

The aim of this chapter is to show how and why the different characterization of a taxpayer, an item of income, and ownership of the financial instrument can arise in cross-border transactions. This description provides a backdrop for dealing with a subset of the different characterization situations in cross-border transactions called hybrid mismatches because it shows what the core issue leading to the occurrence of hybrid mismatches in international taxation is, *i.e.* an uncoordinated exercise of tax sovereignty by countries (jurisdictions). I use this description to join other scholars in arguing that coordination rules provide a better solution to hybrid mismatches arrangements than linking rules in the following chapters. I also want to establish a necessary theoretical background showing what legal systems deal with cross-border taxation and what is the hierarchy of legal norms in international taxation from the perspective of EU Member States. This analysis aids in building the argument that the ATAD's linking rules tax policy aim is *formal* single taxation and that EU Member States can use coordination rules under the ATAD. Also, the discussion on international taxation sometimes gets murky regarding what a tax theory statement is, what a tax policy aim is, and what the actual legal rule is. To avoid such confusion, I also briefly discuss differences between tax theory, tax policy, and tax law.

To achieve this, I first describe the elements relevant for countries to establish their tax jurisdiction over a cross-border income, *i.e.* residence, source, and definition of taxpayer and income. Then, I show where law defines these elements and which legal systems contain rules dealing with cross-border income taxation from the perspective of the EU Member State, *i.e.* domestic law, EU law, and public international law. Following this, I show what the relationship between these legal systems in international taxation is. Subsequently, I describe how legal rules of these systems can classify one element differently and what common ways of dealing with such mismatches are. Lastly, I discuss what tax theory, tax policy, and tax law are, how their statements differ, and how they influence each other.

2.2. Elements Relevant for Establishing Tax Jurisdiction over Cross-Border Income

International income taxation deals with the question of how to tax a cross-border income.[79] To tax the cross-border income, a state has to establish its tax jurisdiction, which basically means

[79] Some authors, however, view the question as regarding taxation of a particular taxpayer and the extent of such taxation. See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN. *Principles of International Taxation*. 6th ed. London: Bloomsbury, 2017, p. 20, 22. ISBN 9781526501691. Other authors consider it as a question of taxing the cross-border activity which consists of two or more countries, a taxable event and a taxable person. See *e.g.*

determining the connecting factors justifying the state's use of the power to tax[80] and enacting a set of necessary rules that effectively establish such jurisdiction.[81] A right to establish the tax jurisdiction is part of the state's sovereignty.[82] However, territorial limits to the state's sovereignty, the sovereignty of other states as well as other legal[83] and factual reasons[84] limit the state's power to tax.[85] Thus, a state can in practice exercise its tax jurisdiction only over income and persons that have some connection to such state.[86] Two bases for the determination of jurisdiction under public international law represent this limitation.[87] These bases are (i) the personal base of the jurisdiction (nationality) and (ii) the territorial base of the jurisdiction (territoriality).[88] The former means that the state has jurisdiction over its nationals no matter where their income arises (the principle of

OSTASZEWSKA, Ola and Belema OBUOFORIBO. *Roy Rohatgi on international taxation: Volume 1: Principles*. Third edition. Amsterdam: IBFD, 2018, p. 10. ISBN 9789087224943. And Helminen uses the term international taxation to refer to taxing cross-border transactions. See *e.g.* HELMINEN, Marjaana, ref. n. 41, p. 31.

[80] OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 9-19.

[81] Brauner writes that the "*typical international income tax system currently consists of several layers of rules that apply to transactions and taxpayers independent of each other, but in a certain, rigid order. These sets of rules, in that order, are: (1) definition of "income" subject to tax, (2) measurement of the tax base and transfer pricing rules, (3) classification of types of income, (4) source (and allocation) rules, (5) taxing provisions, including rates and timing, (6) relief of domestic taxation under domestic rules, (7) relief of domestic taxation claiming tax treaty benefits, and (8) means of collection-mainly withholding tax rules. These sets of rules may be visualized as a pyramid of rules or as a long corridor of analysis, where the result of the application of any set of rules allows the taxpayer to continue its analytical journey to the next set of rules, but only through a specific path. In analyzing an international tax question one cannot skip any of the above sets of rules*". BRAUNER, Yariv. An International Tax Regime in Crystallization. *Tax Law Review*. New York: NYU, 2003, 56(2), p. 266.

[82] Oberson states that "*The power to levy taxes is one of the key features of the Sovereignty of States.*", see OBERSON, Xavier. *International Exchange of Information in Tax Matters*. 2nd ed. Elgar Publishing, 2018, p. 1. DOI: https://doi.org/10.4337/9781786434739.00008. ISBN 9781786434739. For a recent discussion of tax sovereignty and jurisdiction see LAGUNA, Félix Daniel Martínez. Abuse and Aggressive Tax Planning: Between OECD and EU Initiatives – The Dividing Line between Intended and Unintended Double Non- Taxation. *World Tax Journal*. 2017, 9(2), p. 192-194.

[83] For EU Member States' limits of taxing sovereignty in direct taxation under the founding treaties see *e.g.* HELMINEN, Marjaana. *EU Tax Law - Direct Taxation*. 2018 edition. Amsterdam: IBFD, 2018, p. 3. ISBN 978-9087224769.

[84] In English see on international public law in general *e.g.* The expanding legal scope of international concern. SHAW, Malcolm N. *INTERNATIONAL LAW: Fifth Edition*. Cambridge: Cambridge University Press, ©2003, p. 42-47. ISBN 978-0-511-07556-8. ; In Czech see *e.g.* CEPELKA, Cestmir and Pavel STURMA. *Mezinarodni pravo verejne (Public International Law)*. Prague: C.H. Beck, 2008, p. 97. ISBN 978-80-7179-728-9. In relation to international taxation, see *e.g.* KYSAR, Rebecca M., ref. n. 12, p. 216, 221.

[85] For a brief discussion about sovereignty and a right to tax see also GARCÍA, Elizabeth Gil. The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime. *World Tax Journal. Amsterdam*: IBFD, 2019, 11(3), p. 306.

[86] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 80, p. 10. Nevertheless, states try to expand their taxation jurisdiction by some rules such as CFC Rules. See *e.g.* AVI-YONAH, Reuven S. *Advanced Introduction to International Tax Law*. Edward Elgar Publishing, 2015, p. 36-42. ISBN 978-1-78195-237-5.

[87] Avi-Yonah argues that these principles are part of customary international public law. See *e.g.* AVI-YONAH, Reuven S. Does Customary International Tax Law Exist? *U of Michigan Law & Econ Research Paper Series, U of Michigan Public Law Research Paper Series*. 2019, 2019(Paper 19-005, Paper 640), p. 1-4. DOI: http://dx.doi.org/10.2139/ssrn.3382203. Nonetheless, this statement is still controversial and certainly a statement that the "*allocation of revenues among nations has always predominantly been derivative of power and politics, not economics and nexus*" is closer to reality. KYSAR, Rebecca M., ref. n. 12, p. 221.

[88] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 22. ; OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 10.

universality)[89], while the latter means that the state has jurisdiction over incomes that arise within its borders no matter where the taxpayer is a resident.[90]

The personal base of taxation serves as a basis for taxation of income founded on the strength of ties[91] a particular taxpayer has to a state. The term *tax residence* represents the necessary level of ties.[92] For individuals, the tax residence can include, for example, physical presence[93], domicile[94], and citizenship[95]. For legal entities, the tax residence commonly denotes a place of effective management, central management or location of control.[96] The use of different criteria for establishing tax residence can lead to situations where two or more countries consider one individual or legal entity as their resident, which leads to multiple residence issues or to situations where an individual or legal entity has tax residence nowhere.[97] States use the tax residence as a connecting factor for worldwide taxation of their tax residents[98] and can also use the tax residence as a basis for taxation of legal entities held by their tax residents using CFC and similar rules.[99] The status of

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[89] Oberson cites Seer and Gabert to explain that states generally have a right to tax persons as long as these persons have certain personal connection to such state, *i.e.* the principle of universality. This approach is an outcome of the conflict between the principle of universality of taxation and the principle of territoriality of implementation of tax laws (rules) because states are "*locked inside their territory in order to implement or enforce their tax rules*". See OBERSON, Xavier, ref. n. 82, p. 1.

[90] OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 10.

[91] As I show below, not only the criteria to determine these ties, but also the definition of what legal entity is, is significant.

[92] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 10-18. ; OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 48, 79.

[93] Common rule is a certain number of days being present in one country with some exceptions, *e.g.* medical treatment or pursuing studies. See *e.g.* Section 2 par. 4 of the CITA. ; OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 11-12. At least theoretically, taxpayers may avoid such a rule by living in three or more countries. AVI-YONAH, Reuven, ref. n. 95, p. 10.

[94] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 12-14.

[95] Avi-Yonah explains that states use tax residence rather than citizenship (nationality) because it would be easy for people to obtain citizenship of a low-tax country, but they could still live in another country which would lower their overall taxation. AVI-YONAH, Reuven S. *Advanced Introduction to International Tax Law*. 2nd ed. Cheltenham: Edward Elgar, © 2019, p. 8. ISBN 9781788978491. However, the U.S. has used citizenship to determine tax residence since 1861. See Section 49 of the Revenue Act of 1861. On the history of taxing citizens in the U.S. see *e.g.* AVI-YONAH, Reuven S. The Case Against Taxing Citizens: *U of Michigan Law & Econ, U of Michigan Public Law Working Paper Series, U of Michigan Law & Econ, Empirical Legal Studies Center Paper Series*. 2010, 2010(Empirical Legal Studies Center Paper 10-009), p. 3-6. DOI: http://dx.doi.org/10.2139/ssrn.1578272.

[96] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 15-17.

[97] That leads to a specific set of double non-taxation situations which I do not cover in the dissertation. For more on the infamous Double Irish With a Dutch Sandwich see *e.g.* 'Double Irish With a Dutch Sandwich'. *The New York Times* [online]. New York: The New York Times, 2018, April 28, 2018 [cit. 2020-07-27]. Available at: https://archive.nytimes.com/www.nytimes.com/interactive/2012/04/28/business/Double-Irish-With-A-Dutch-Sandwich.html?ref=business topic. For the discussion of less complex but also effective double non-taxation Apple case *e.g.* TING, Antony. iTax - Apple's International Tax Structure and the Double Non-Taxation Issue. *British Tax Review*. 2014, 2014(1), p. 40-71.

[98] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 20.

[99] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 549-590. ; AVI-YONAH, Reuven S., ref. n. 86 p. 34-36. ; POSTLEWAITE, Philip F., Genevieve A. TOKIC, Jeffrey T. SHEFFIELD and Mitchell B. WEISS. *United States International Taxation: Fourth Edition*. Durham: Carolina Academic Press, 2019, p. 243-284. ISBN 978-1-5310-1118-5. ; WENZEL, Peter. *Making Germany's CFC Rules Effective Again: A Comparative Analysis to Spain's and UK's CFC Rules to Find the Best ATAD Compliant Approaches Provided in the OECD/G20's Report on Designing Effective CFC Rules*. Murcia, 2019. Dissertation. UCAM Universidad Católica San Antonio de Murcia. ;

residence is also important for an application of double tax treaties because only tax residents have a right to double tax treaty benefits.[100]

The territorial base of taxation is important for taxation of income founded on the location of the income source.[101] The concept of income source thus divides items of income between countries based on where the income has its source.[102] This division is problematic because it is impossible for an economist to precisely distinguish where income has its source.[103] From the legal perspective, on the one hand, public international law does not contain general source rules.[104] On the other hand, domestic laws contain source rules that tend to be similar across states.[105] Domestic tax law usually contains a list enumerating types of incomes which have their source in that state (within its borders) based on criteria also stipulated in the list.[106] The criteria for distinguishing a source jurisdiction of an income are, for instance, the payer's residence (*e.g.* for dividends, interest), the seller's residence (*e.g.* for capital gains), permanent establishment's locations, or the real estate's location.[107] Scholars infer a few principles regarding what criteria are used for what kind of an income, *i.e.* active income and passive income, based on the current rules governing the international taxation in states and on the criteria that international treaties use for these purposes. Active income traditionally means an income "*from activities that the taxpayer controlled such as business income and wages*"[108], *e.g.* business profits and income from employment.[109] Countries primarily source active

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HERZFELD, Mindy. Can GILTI + BEAT = GLOBE? *INTERTAX*. 2019, 47(5), p. 504-505. DOI: http://dx.doi.org/10.2139/ssrn.3436997. ISSN 0165-2826. ; BONN, Jens Schönfeld. CFC Rules and Anti-Tax Avoidance Directive. *EC Tax Review*. 2017, 26(3), p. 145-152. ISSN 0928-2750.

[100] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 11. ; Article 1(1) of the OECD DTC Model.

[101] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 10.

[102] See *e.g.* BRAUNER, Yariv, ref. n. 81, p. 278.

[103] Bradford and Ault state that "*the source of income is not a well-defined economic idea*". BRADFORD, David F. and Hugh J. AULT. Taxing International Income: an Analysis of the U.S. System and its Economic Premises. NBER Working Paper. 1989, 1989(w3056), p. 26. Available at: https://ssrn.com/abstract=979953 See also *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 13.

[104] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 19. However, as I briefly wrote in Chapter 1, the OECD and the European Commission newly proposed the *value creation* as a guidance for tax policy in regard to sourcing income. According to Kysar, value creation has positive and negative accounts. The positive account of value creation means that "*the jurisdiction in which value is created has the taxing jurisdiction over the income*". The negative account of value creation means that "*the jurisdiction in which value is not created cannot have jurisdiction over the income*". KYSAR, Rebecca M., ref. n. 12, p. 216. However, as Kysar states, production countries as well as market countries add value and finding criteria on which distribute income according to value creation is arbitrary. See *ibid*, p. 216-217.

[105] See *e.g.* BRAUNER, Yariv, ref. n. 81, p. 280-282.

[106] See *e.g.* Section 22 of the CITA ; POSTLEWAITE, Philip F., Genevieve A. TOKIC, Jeffrey T. SHEFFIELD and Mitchell B. WEISS, ref. n. 99, p. 25-41.

[107] AVI-YONAH, Reuven S., Diane RING and Yariv BRAUNER. *U.S. International Taxation, Cases and Materials*. 4th ed. Foundation Press, 2019, p. 40. ISBN 978-1683286509. See Section 22 of the CITA for the Czech source list.

[108] AVI-YONAH, Reuven S., ref. n. 95, p. 13.

[109] AVI-YONAH, Reuven S., ref. n. 95, p. 13.

income where the activity takes place.[110] Passive income means generally "*income from investments not controlled by the taxpayer*"[111], *e.g.* dividends, interest, royalties, and rents.[112] Countries primarily source it where investors providing capital reside.[113] Rules sourcing active income where the activity takes place and passive income where the capital comes from are not random but represent the benefits principle. This principle states that "*active (business) income should be taxed primarily at source while passive (investment) income should be taxed primarily on a residence basis*"[114] and Avi-Yonah argues that this principle is embodied to some extent in national laws as well as double tax treaties.[115] Sourcing rules are either formal or substantive.[116] Formal rules are "*rules which leave control over the source of income to the taxpayer and do not attempt to track the economic source of income*"[117] and commonly apply to passive income "*because that income is supposed to be taxed primarily on a residence basis*".[118] Substantive rules are the rules that "*seek to track the economic source of the income*"[119] and usually apply to active income "*because the source country has more of an interest in attributing this type of income to its economic source since it gets to tax it*".[120] Examples of domestic formal rules are the payer's residence (*e.g.* for dividends, interest) and the seller's residence (*e.g.* for capital gains).[121] Examples of domestic substantive rules are a place of use (*e.g.* for royalties, rents), a place of provision (*e.g.* for services), and a place of location (*e.g.* for real estate).[122] States use source as the connecting factor for territorial taxation of its non-tax residents on income that has the location of source within the state.[123]

Theoretically, countries could tax income exclusively based either on residence taxation or source taxation. In practice nonetheless, tax policymakers prefer a combination of worldwide taxation or territorial taxation.[124] Pure worldwide taxation taxes every income which a tax resident has earned no matter where.[125] Pure territorial taxation taxes only income that has a source within

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[110] See *e.g.* Article 7 par. 1 and Article 15 par. 1 and 2 of the OECD DTC Model. ; AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[111] AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[112] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 265-270.
[113] AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[114] AVI-YONAH, Reuven S., ref. n. 95, p. 4.
[115] AVI-YONAH, Reuven S. *INTERNATIONAL TAX AS INTERNATIONAL LAW: An Analysis of the International Tax Regime*. Cambridge: Cambridge University Press, © 2007, p. 1. ISBN 978-0-511-51131-8. See also a discussion in Chapter 4 in relation to the single tax principle.
[116] AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[117] AVI-YONAH, Reuven S., Diane RING and Yariv BRAUNER, ref. n. 107, p. 36. Similarly Avi-Yonah states that formal rules "*rather seek to achieve administrative ease and certainty*". AVI-YONAH, Reuven S., ref. n. 115, p. 42.
[118] AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[119] AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[120] AVI-YONAH, Reuven S., ref. n. 95, p. 13.
[121] AVI-YONAH, Reuven S., Diane RING and Yariv BRAUNER, ref. n. 107, p. 40-41.
[122] AVI-YONAH, Reuven S., Diane RING and Yariv BRAUNER, ref. n. 107, p. 40-41.
[123] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 10, 19.
[124] France used to be one of countries with territorial regime. See *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 6.
[125] See *e.g.* VANN, Richard. Chapter 18: International Aspects of Income Tax. THURONYI, Victor T. *Tax Law Design and Drafting: Volume 2*. Washington, D.C.: International Monetary Fund, 1998, p. 11. ISBN 9781557756336. ; OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 20-21.

the borders of the state (particular area) and does not recognize (exempts) any foreign income of the state's tax resident.[126] States usually tax their tax residents' worldwide income whereas they tax non-residents' income only if the source of the income is within such state's borders.[127] On the one hand, this may lead to overlapping tax duties because a tax resident's income can be subject to tax under two legal systems, *i.e.* twice, due to her tax residence in Country A and source of her income in Country B. This is a model example of one situation where legal systems may interact and the example shows why multiple taxation situations can arise and also why multiple taxation is common since the combination of worldwide taxation and territorial taxation system is the prevailing form of domestic tax system design. On the other hand, taxpayers or legal entities with no tax residence or who are exempt from taxation can derive an income that does not have a source country and thus no country taxes such income.[128] This is another model example of how legal systems may interact and why non-taxation situations can arise. These two outcomes are crucial for the purpose of this study because the non-taxation, single taxation, and multiple taxation are at the heart of the hybrid mismatches issue as I discuss it later.[129] Therefore, it is essential to identify which rules define who a taxpayer is and where the source of income is to properly deal with hybrid mismatches scenarios.

Although the tax residence and income source play a fundamental role in international taxation, they are not the only elements necessary to properly establish an income tax over an income.[130] Countries have to stipulate in their tax laws other rules defining especially who is a taxpayer (whose income is subject to tax) and what does constitute an income (what the tax base is), and what does not constitute an income (what is excluded from the tax base, *e.g.* exemptions, deductions, and losses).[131]

While the subject of income tax is, of course, income, the puzzling question is: "*What is "income" anyway?*"[132] Regarding an economic answer to this question, scholars and tax policymakers

[126] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 20-21.

[127] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 20. For the Czech example see Section 2 par. 2 and 3 of the CITA for individuals and Section 17 par. 3 and 4 of the CITA for corporate taxpayers.

[128] The practical example involves the Apple case. Avi-Yonah and Xu pinpoint one aspect of this case from hearing before the Permanent Subcommittee on Investigations stating that "*Ireland has a tax rate of 12.5 percent, far below the U.S. rate of 35 percent. But Apple did not want to pay even 12.5 percent. Its solution: for U.S. tax purposes, Apple Ireland is treated as an Irish company because it is incorporated in Ireland, so it is not taxed by the United States. But for Irish tax purposes, Apple Ireland was treated as an American company because it is "managed and controlled" from California. As a result, Apple Ireland claimed it was a tax resident nowhere*". See *e.g.* AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 12, p. 193.

[129] See Chapters 3 and 4.

[130] See *e.g.* BRAUNER, Yariv, ref. n. 81, p. 266.

[131] In fact, countries have to come up with a complex set of rules to properly tax an income containing many building blocks. Nevertheless, I am mentioning only those elements of income tax which play role in hybrid mismatches. See supra ref. n. 81. For a thorough discussion about general income taxation see *e.g.* BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD. *Federal Income Taxation: Seventeenth Edition*. New York: Wolters Kluwer, 2017. ISBN 978-1-4545-7102-6. ; MCCAFFERY, Edward, ref. n. 57, p. 1-410.

[132] BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 55.

generally accept the Schanz-Haig-Simons's economic definition of income,[133] which can be expressed for individuals as:

$$Y = C + \Delta W$$

where Y stands for income, C for consumption and ΔW for change in net worth during some time.[134] Similarly, for an entity, the "*analogy of personal consumption is distributions to shareholders*".[135] Unfortunately, this definition has normative as well as practical weaknesses and real tax systems often depart from the theoretical definition.[136] But income tax laws still have to somehow define the income.[137] Countries usually do not use one all-encompassing definition of income in their tax laws[138] Instead, legislators state some general or specific concept of income and use for these purposes a combination of Schanz-Haig-Simons's definition as a global definition of income (*global model*) plus lists stipulating items constituting an income, and/or use accounting rules to establish the tax base (*schedular model*) leading to a combination of both approaches toward stating what is not an income, what is an income and which category of income the item is (*mixed model*).[139] Furthermore,

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[133] Also called *accretion income concept*. See *e.g.* BRADFORD, David F. and Hugh J. AULT, ref. n. 103, p. 26-28. This concept „*defines income as an increase in economic power which can be measured with reasonable objectivity. For an individual, income for a period equals the change in economic power during the period plus the value of goods and services consumed. For other entities, income is the change in economic power adjusted for capital contributions and distributions*". PHILIPS, Edward G. Accretion Concept of Income. *Accounting Review*. 1963, 38(1), p. 14. ISSN 0001-4826.

[134] See *e.g.* BRAUNER, Yariv, ref. n. 81, p. 267-271. ; BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 48-51, 413-414. ; THURONYI, Victor. *Comparative Tax Law*. Great Britain: Kluwer Law International, 2003, p. 233-241. ISBN 90-411-9923-3. ; BOADWAY, Robin. *From Optimal Tax Theory to Tax Policy: Retrospective and Prospective Views*. Cambridge, MA: Massachusets Institute of Technology, 2012, p. 16. ISBN 978-0-262-01711-4. For the discussion about the Czech statutory income definition in Czech see *e.g.* Tax Law and Economics Suggestions for the New Income Tax Act. AUC IURIDICA. 2018, 2018(1), p. 91-100. DOI: 10.14712/23366478.2017.42. ISSN 2336-6478. Available at: http://www.karolinum.cz/doi/10.14712/23366478.2017.42.

[135] BRADFORD, David F. and Hugh J. AULT, ref. n. 103, p. 29.

[136] See *e.g.* MCCAFFERY, Edward J. A New Understanding of Tax. *Michigan Law Review*. Ann Arbor, 2005, 103(5), p. 885-899. Available at: https://repository.law.umich.edu/mlr/vol103/iss5/1. ; BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 55-58, 132-282. ; BRADFORD, David F. and Hugh J. AULT, ref. n. 103, p. 26-29.

[137] Klaus Vogel comments that "*there is at international level a basic common understanding of what 'income', the French term 'revenue' , and the German term 'Einkommen' mean….The positive definitions of the term 'income' in national income tax legislation usually are much narrower than the widest of all definitions of the term*". VOGEL, Klaus. *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation of Income and Capital with Particular Reference to German Treaty Practice*. 3rd ed. Kluwer Law and Taxation Publishers, 1991, p. 89. ISBN 9065444475.

[138] For example, the CITA uses a complex set of specific rules to define what income is and what income is not (see *e.g.* Section 3-10 and Section 23 and following of the CITA) for individual taxpayers; then the CITA uses the Schanz-Haig-Simons general definition as a "safety break" in Section 10 par. 1 of the CITA for a possibility of interpretation in the case a particular even would not be otherwise taxed under previous provisions (Section 10 of the CITA applies subsidiarily, see Section 10 par. 1 of the CITA). Similarly, for instance, the US have in their § 61(a) of the IRC gross income definition stating that gross income is generally "*all income from whatever source derived, including (but not limited to) the following items*".

[139] "*Two theoretical models exist for the structure of the personal income tax—schedular and global. A schedular income tax is one in which separate taxes are imposed on different categories of income. A global income tax is one in which a single tax is imposed on all income, whatever its nature.*" BURNS, Lee and Rick KREVER. Chapter 14: Individual Income Tax. THURONYI, Victor. *Tax Law Design and Drafting: Volume 2*. Washington, D.C.: International Monetary Fund, 1998, p. 1. ISBN 9781557756336. For the comparative discussion and discussion of the UK rules see HARRIS, Peter. *Corporate Tax*

domestic tax laws display parallels in many areas, including their approach toward the definition of income.[140] Thus, the paramount definition of income is in practice the legal (statutory) concept of income,[141] sometimes accompanied by a juridical definition of income.[142] For the rest of the dissertation, I am using the concept of income in the legal sense, *i.e.* income is an item that relevant tax law provisions (legal norms) consider as an income, and I disregard economic definitions of income for the purpose of my argument. Countries may differ in what they recognize as income, which can also lead to mismatches and perhaps to the existence of non-taxed income in a case that no country recognizes a certain item as an income under their law. Such a situation could lead to lower taxation in a hypothetical case when the source country perceives a payment as deductible, *e.g.* interest, and the payee country would not consider such payment as giving rise to income.

No matter how much tax legislators try to be specific with the income definition, some payments which resemble income do not fulfill the income definition. These payments thus are either exempted or deducted from the tax base to align statutory income definition with the theoretical definition. A typical example of such payment is when a debtor receives money from her lender.[143] The reception of money might constitute income under the *cash method* of income recognition (as opposed to the *accrual method* of income recognition).[144] However, obtaining loan principal does not constitute income under the Schanz-Haig-Simons's income definition because it is not consumption and it does not lead to a change in net wealth.[145] Thus, a tax legislator has to

Law: Structure, policy and practice. Cambridge: Cambridge University Press, 2013, p. 79-88. ISBN 978-1-107-03353-5. ; THURONYI, Victor, ref. n. 134, p. 231-243.

140 BRAUNER, Yariv, ref. n. 81, p. 267-271.

141 For the discussion in US context, see *e.g.* BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 56.

142 See *e.g.* BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 58, briefly discussing the judicial definition of income in the US. See also *ibid*, p. 61-64, for a discussion of Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-430 (1955).

143 For an amazing theoretical analysis of debt in income tax see MCCAFFERY, Edward J, ref. n. 136, p. 827-829. For a practical discussion see also *e.g.* BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 316-318.

144 "*Two major systems of annual accounting for income are the cash method and the accrual method. The cash method focuses on actual receipts and disbursements, while the accrual method focuses on amounts earned (though not necessarily received) and obligations incurred (though not necessarily paid)*". BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 206. For the discussion of these two principles from the US perspective, see BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 206-228. The CITA also distinguishes between these two principles but implicitly. The CITA uses predominantly cash method to identify individual's income whereas the law uses accrual method to identify corporate income. See *e.g.* Section 5 par. 1 of the CITA using a term "*vynaložené*" (spent) regarding individuals and Section 21h of the CITA stating that the financial accounting (using generally accrual principle) forms the basis for corporate income taxation.

145 Debtor receives money but also has a duty to return them. Therefore, the net wealth does not change. This applies as long as a taxpayer has the duty to return money in the future. See also BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 316-317, for an example using "*a pure cash flow measure of gross income*", to explain tax issues while dealing with such debt agreements and present value concerns.

exempt the reception of a loan from the tax base.[146] This is only one example of why certain items of income are exempt from taxation or deducted from taxable income, *e.g.* to avoid double economic taxation.

Certain exemptions and deductions are common to tax design.[147] For the purpose of hybrid mismatches study, the paramount exemptions and deductions are (i) participation exemption and (ii) interest deduction.

Participation exemption exempts a dividend income of a taxpayer who owns a certain share in a corporation.[148] The aim of participation exemption is to prevent double (or multiple) economic taxation which would occur because without this exemption income of a corporation distributing its dividend would be taxed under corporate income taxation and, subsequently, again under individual or corporate income tax as shareholder's income.

The interest deduction is another example of a common tax design feature,[149] but also a Trojan horse full of tax avoidance schemes because many tax avoidance techniques utilize it to lower corporate tax base.[150] In general, interest is "*the cost of borrowing money*" and "*can be thought of as the price one pays for accelerating access to financial resources that would otherwise only be available in the future*".[151] Although the Schanz-Haig-Simons's income definition does not call for interest tax deductibility[152] and scholars have suggested other income tax designs[153], interest payments are still mostly deductible from a corporate taxpayer's tax base in practice.[154] The reasons for this are thus surprisingly not

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[146] In the Czech Republic, see *e.g.* Section 3 par. 4 letter b) of the CITA.

[147] See *e.g.* BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 413-474, 575-632.

[148] The IBFD Glossary defines participation exemption (under the definition of *affiliation privilege*) as "*Tax relief accorded to a company in respect of distributions it receives from, or (in some instances) capital gains it realizes on certain shareholdings in another company, typically where the shareholding exceeds a certain minimum percentage or acquisition cost. A minimum holding period may also be required. The relief generally takes the form of an exemption from tax but can take other forms, such as a deduction from taxable income equal in amount to the benefited income. In some cases a small proportion of the income remains, in effect, taxed. The affiliation privilege may be restricted to shares in resident companies or may extend to shares in foreign companies. It is primarily intended to mitigate double economic taxation of income in the corporate sphere*".

[149] And a very problematic one which violates the tax neutrality principle (see Chapter 4 on the tax neutrality principle). On the discussion and for reasoning behind differences in handling equity and debt in taxation (*e.g.* because of the realization principle) leading to a "*debt bias*", see *e.g.* SCHÖN, Wolfgang. The Distinct Equity of the Debt Equity Distinction. *Bulletin for International Taxation*. 2012, 66(9), p. 490-502.

[150] For example, the combination of single taxation of interest (compared to at least double taxation of equity investment) and prevalent low withholding taxation of outgoing cross-border interest payment in a source jurisdiction makes interest a lucrative form of financing possibly leading to low taxation in the source jurisdiction as well as residence jurisdiction. See *e.g.* SCHÖN, Wolfgang, ref. n. 149, p. 500, stating that "*this wide-reaching waiver of source taxation on outbound interest contributes greatly to the tax planning, tax arbitrage and tax avoidance around the globe*".

[151] BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 620.

[152] See *e.g.* SCHÖN, Wolfgang, ref. n. 149, p. 492. In regard to asymmetrical treatment of interest income and expense, see BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 621.

[153] See *e.g.* SCHÖN, Wolfgang, ref. n. 149, p. 500-502.

[154] See *e.g.* BLESSING, Peter H. The Debt-Equity Conundrum - A Prequel. *Bulletin for International Taxation*. 2012, 66(4/5), p. 205-207.

economic[155] but rather formal. Income tax discerns between sometimes deductible interest and usually non-deductible equity. This distinction represents dividing historical views of commercial law on debt financing as a contract and corporate law on equity financing as a duty toward an owner (shareholder).[156] Probably on these historical grounds, most countries enact interest deductibility in relation to commercial income with a view that "*interest incurred on a contractual obligation represented an expense for an asset, money, to be used to derive income and, therefore, a tax on net income must necessarily be imposed on an amount net of that expense*" similarly to, for instance, rent.[157] Thus, the tax policymaker presumes that some other taxpayer is going to include interest income into her tax base. In domestic situations, this is always going to be the case unless the tax policymaker exempts interest income for some reason, *e.g.* the lender is an investment fund that is not subject to income taxation, or decides not to allow the interest deduction, *e.g.* because a taxpayer uses the interest to lower her tax duty. In cross-border situations, this is not necessarily the case. Under certain conditions, the country of the payer may allow a deduction of the interest payment without a corresponding (withholding) taxation and allow the lender's country to tax the interest income. However, since this is not generally done on a case-by-case basis but under generally applicable tax legal norms, another country may consider the payment a dividend payment and instead of including this payment in the lender's tax base, exempts it as the dividend. That choice ultimately leads to non-taxation of such income. This is one example of a hybrid mismatch situation (debt-equity hybrid financial instrument) and shows also one explanation behind these mismatches, *i.e.* some domestic (intra-border) rules do not work properly in cross-border settings.

To properly tax income, tax law also has to define who a taxpayer is.[158] For individual income tax, it is an individual.[159] For corporate income tax, the situation is thorny. Firstly, the complexity stems from tax policymakers' decision to include corporate income tax into the tax system, *i.e.* to enact the separate entity principle.[160] This decision in itself makes the tax system complex because it creates corporate income tax which is separate from individual income tax and establishes a set of relationships between these two taxes. Secondly, the tax policymaker has to

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155 See *e.g.* BLESSING, Peter H., ref. n. 154, p. 207-208.

156 BLESSING, Peter H., ref. n. 154, p. 206.

157 BLESSING, Peter H., ref. n. 154, p. 206. For a brief introduction to Czech interest deductions and its limitations see in Czech, see *e.g.* VYCHOPEN, Jiri. *Income Tax 2019.* Praha: Wolters Kluwer, 2019, p. 244-246. Meritum (ASPI). ISBN 978-80-7598-325-1.

158 See *e.g.* HARRIS, Peter, ref. n. 139, p. 19.

159 See *e.g.* BURNS, Lee and Rick KREVER, ref. n. 139, p. 1. In the Czech Republic see Section 2 par. 1 of the CITA. In fact, it does not even have to be a living individual. Dead individual sometimes suffices for tax law purposes. See *e.g.* Section 239b of the Act No. 280/2009 Sb. (Coll.), Czech Tax Process Code, as amended.

160 SCHWARZ, Stephen and Daniel J. LATHROPE. *Fundamentals of Corporate Taxation: Cases and Material.* Ninth Edition. United States of America: Foundation Press, 2016, p. 3-5. ISBN 978-1-63459-602-2. For a summary of arguments against and in favor of this principle see *e.g.* AVI-YONAH, Reuven S. A New Corporate Tax. *Tax Notes International.* 2020, 2020(July 27, 2020), p. 497-504.

decide which legal entities[161] are taxpayers (*fiscally non-transparent*), to what extent (*fully* or *partially fiscally non-transparent*) and which legal entities are not taxpayers (*fiscally transparent* or *pass-through entities*).[162] Tax policymakers use various approaches toward enumerating which legal entities are taxpayers and to what extent. The codification of this decision is challenging even under domestic-only scenarios.[163] Lastly, the complexity rises exponentially when tax policymakers have to deal with foreign legal entities that derive taxable income in the policymaker's jurisdiction or otherwise interact with the tax system of her jurisdiction.[164] Currently, no "*inviolable system of characterization of foreign entities for tax purposes*"[165] exists and no approach of countries to classifying domestic and foreign legal entities "*prevails over the other*"[166]. Therefore, it is up to every state to decide what rules to apply to classify foreign legal entities for its tax law purposes.[167,168] These approaches are the following: (i) comparative approach or resemblance test, (ii) legal personality approach, (iii) overall approach, (iv) fixed approach, and (v) elective approach.[169] The resemblance test recognizes the foreign entity as a taxable entity if there is certain comparability or equivalence degree to domestic taxable entities.[170] The legal personality approach grants taxable status to legal entities that have

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[161] The IBFD Tax Glossary describes a legal entity in these words: "*The civil or company law definition of a legal entity can vary from country to country but in general it may be described as a body having legal existence separate from its owners or participants (i.e. separate legal personality), such that it is capable of having its own rights and incurring its own liabilities. In most countries a company is a legal entity while a general partnership is not. In most countries there tends to be a correlation between legal entities and taxable subjects: a legal entity is typically treated as a separate taxpayer, distinct from its owners or participants. However, this is not necessarily the ase and there are cases where a legal entity will be treated as transparent for tax purposes and cases where a body that is not a legal entity is treated as a separate taxable subject.*"

[162] "*However, just because corporations have, own or derive income as a legal fact does not mean that a tax law must respect the corporation's separate legal identity for tax purposes. A tax law, for its purposes, may override the corporate law prescription that a corporation is a person and ignore the separate legal personality of the corporation. Similarly, just because the law does not imbue an entity with separate legal personality does not mean that a tax law may not treat that entity as having and deriving its own income. In identifying entities that are the subject of a corporate tax system, a tax law may be both broader and narrower than the entities that are imbued with separate personality by law*". HARRIS, Peter, ref. n. 139, p. 17. Pass-through regime generally means that states tax income of pass-through entity once on the level of legal (beneficial) owners of such an entity and losses may also pass through to the owners. See for the short description of the regime in the US *e.g.* SCHWARZ, Stephen and Daniel J. LATHROPE, ref. n. 160, p. 5.

[163] For a discussion about various approaches see *e.g.* HARRIS, Peter, ref. n. 139, p. 19-33.

[164] For an introduction to this issue see *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 33-34, 323-346. For the a detailed discussion see *e.g.* PARADA, Leopoldo, ref. n. 8, p. 109 and following.

[165] PARADA, Leopoldo, ref. n. 8, p. 109.

[166] PARADA, Leopoldo, ref. n. 8, p. 109.

[167] Thus, differences between countries in their decisions regarding which legal entities count as taxpayers can lead to a subset of hybrid mismatches, *i.e.* hybrid entities. See Chapter 3.3.

[168] PARADA, Leopoldo, ref. n. 8, p. 109. For differences between civil law and common law countries as well as the approaches toward defining legal entities, distinguishing between domestic and foreign legal entities, and examples of rules governing the distinction between taxable and nontaxable legal entities, see *e.g.* PARADA, Leopoldo, ref. n. 8, p. 110-115. For the explanation of how corporate taxpayers could have achieved an outcome where they were tax residents nowhere using Irish tax law, see PARADA, Leopoldo, ref. n. 8, p. 113.

[169] PARADA, Leopoldo, ref. n. 8, p. 109. However, Kahlenberg recognizes only three approaches, *i.e.* similarity approach, elective approach, and fixed approach. See KAHLENBERG, Christian. Hybrid Entities: Problems Arising from the Attribution of Income Through Withholding Tax Relief – Can Specific Domestic Provisions be a Suitable Solution Concept? *Intertax*. 2016, 44(2), p. 147-148.

[170] PARADA, Leopoldo, ref. n. 8, p. 118. For German and Dutch examples of the resemblance test, and subsequent discussion of the benefits and shortcomings of this test, see PARADA, Leopoldo, ref. n. 8, p. 118-121.

a separate legal personality.[171] The overall approach considers comprehensively the foreign entity by the domestic tax law perspective.[172] The fixed approach views all foreign entities in the same preset way, *i.e.* either fiscally transparent or non-transparent.[173] The elective approach is where "*the taxpayer can elect the tax status of a determined foreign entity*".[174] As regards the hybrid mismatches, specifically hybrid entities, the crux of the issue lies in the U.S. using the elective approach in the "check-the-box" regulations that allow MNEs to structure their business in a way that allows them to elect whether the legal entity is tax transparent or non-transparent.[175]

In general, the CITA uses predominantly terminology of Czech private law to establish income taxation.[176] Nonetheless, the CITA has to deal also with taxation of foreign entities. The Czech Republic therefore uses a combination of legal personality approach[177,178] and enumeration of specific legal entities that lack a general legal personality under Czech private law but which are granted a specific tax legal personality by the CITA, *e.g.* Czech mutual fund[179] and Czech trust[180]. To deal with situations of possible qualification mismatch, the CITA uses a coordination rule stating that any entity which is a taxpayer in the country where the entity is incorporated is also a taxpayer for the purposes of the CITA.[181] The Czech legal order itself contains two legal entities which are legal persons, the CITA considers them as taxpayers, but they are fully or partially fiscally transparent.[182] The CITA does not deal explicitly with transactions containing fiscally transparent foreign entities. The paramount example of such an entity in Czech cross-border transaction is GmbH&Co KG. The discussion about dealing with the classification of this entity led to the current Czech practice when dealing with foreign entities.[183] During the process, the Ministry of Finance

[171] PARADA, Leopoldo, ref. n. 8, p. 122. See also for Belgium and Switzerland as examples, *ibid*, p. 122-123.
[172] PARADA, Leopoldo, ref. n. 8, p. 124-127. The example is the UK. See *ibid*.
[173] PARADA, Leopoldo, ref. n. 8, p. 128. Examples include Greece, Italy, Portugal, and Luxembourg. See *ibid*.
[174] PARADA, Leopoldo, ref. n. 8, p. 128. The only example is the US, *ibid*, p. 129-157. For a brief discussion about the classification of US corporations and partnerships see *e.g.* SCHWARZ, Stephen and Daniel J. LATHROPE, ref. n. 160, p. 32-39.
[175] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 369-371.
[176] SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA, ref. n. 75, p. 215.
[177] The legal personality approach uses the legal entity's legal personality status under private law to determine its tax status. For the comparative discussion of the term see *e.g.* PARADA, Leopoldo, ref. n. 8, p. 113-115.
[178] See Section 17 par. 1 letter a) of the CITA stating that "*The taxpayer of the corporate income tax is legal person*". Since Section 17 par. 1 letter a) of the CITA uses a term *legal person* without using reference to Czech law. Current interpretation of the CITA by the Ministry of Finance states that this legislative technique means that the term legal person thus encompasses also legal persons under foreign laws. See the Explanatory Memorandum to Section 23f to the Act No. 80/2019 Sb. (Coll.), amending some tax laws and some other laws, p. 170. Available at: https://www.psp.cz/sqw/text/tiskt.sqw?O=8&CT=206&CT1=0.
[179] See Section 17 par. 1 letter c) of the CITA.
[180] See Section 17 par. 1 letter f) of the CITA.
[181] See Section 17 par. 1 letter g) of the CITA.
[182] See Section 18b par. 1 of the CITA.
[183] SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA, ref. n. 75, p. 215-218.

issued at least four statements dealing with the German entity which is fiscally transparent from the German perspective.[184] The outcome of the statements is that Czech tax administrators perceive foreign entities in the same way as the country of incorporation or where the seat, *i.e.* home country.[185] Unfortunately, statements include no explanation of why such an approach works under the CITA and why this approach is in accordance with law in general.[186] The statement only vaguely mentions the double tax treaty between the Czech Republic and Germany but does not mention Czech domestic law and states that tax administrators should apply this approach to other fiscally transparent entities as well.[187] The statement is binding on Czech tax administrators until the relevant administrative practice changes.[188] However, the perception of entities for tax treaty reasons is separate from the perception under domestic law,[189] so it is still questionable if this approach applies under the CITA or only for the application of relevant double tax treaties' benefits.

2.3. Finding Relevant Elements: Legal Systems in International Taxation

The whole legal world consists of many legal systems. For this work, the relevant legal systems are domestic (national) legal systems, the international legal system and the supranational legal system. Domestic (national) legal systems consist of legal norms effective in relation to the jurisdiction enforced by this jurisdiction (commonly a state). The international legal system refers to the legal norms arising out of international public law. From the EU Member States' perspective, the key supranational legal system is EU law that is a separate legal system but the EU law legal norms are considerably entwined with national legal systems. To deal properly with a cross-border income in the EU area, each of these legal systems has to be considered.[190]

As regards the domestic perspective, countries have to use them to establish tax jurisdiction over a particular income. Hence, domestic legal systems are largely responsible for stating (i) who is a taxpayer, (ii) which taxpayers are tax residents, (iii) where the source of income is, (iv) what constitutes income under income tax law, *i.e.* what the tax base is, and (vi) other main elements of income taxation. Therefore, rules governing questions of tax residence and source of income, what

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184 SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA, ref. n. 75, p. 216-218.

185 SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA, ref. n. 75, p. 215-218.

186 SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA, ref. n. 75, p. 215-218.

187 SOJKA, Vlastimil, Monika BARTOSOVA, Pavel FEKAR, Jan MASEK, Matej NESLEHA and Ivana VANOUSOVA, ref. n. 75, p. 275. See also Statement n. 15/32 567/2006-153 regarding transparent entity deriving income with source in the Czech Republic.

188 See in Czech KUBIK, Jaroslav. Tax Process: Case Law Regarding Problematic Situations. Olomouc: ANAG, [2016], p. 23. Dane (ANAG). ISBN 978-80-7554-029-4.

189 See below.

190 For a similar reasoning see *e.g.* HELMINEN, Marjaana, ref. n. 41, p. 31.

income is, what income is exempt, what expense is deductible, and who is a taxpayer, are primarily enacted in domestic law because states have the right to structure their national and international tax policy and tax system. Domestic legal systems thus inevitably establish a framework for taxing cross-border income.

As regards the international perspective, states are legal subjects of public international law and have sovereignty.[191] Part of the state's sovereignty is a right to tax, *e.g.* income.[192] But this right is not infinite. The sovereignty of other states, territorial constraints on the state's sovereignty execution, and public international law limit a state's right to tax a cross-border income.[193] Public international law has two binding legal sources, *i.e.* international treaties and legal customs.[194]

International treaties[195], in particular double tax treaties, play an essential role in international taxation. They are at the core of international taxation and what some call the international tax regime.[196] International tax treaties are traditionally bilateral (*e.g.* double tax treaties, TIEAs) but a multilateral approach has become common recently (*e.g.* MLI[197], Nordic Convention[198], Andean Pact, CARICOM).[199] The fundamental source of public international law in international taxation is double tax treaties. These treaties contain rules dealing with (i) distributing the right to tax between states and (ii) specific tax administration (tax process) provisions that allow states to co-operate in tax matters.[200] Double tax treaties "*operate through domestic law by limiting or modifying the application of domestic law but not by creating a new taxing right*".[201] Substantial provisions of double tax treaties thus

[191] See *e.g.* SHAW, Malcolm N., ref. n. 84, p. 181. ; RING, Diane M. Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation. *Florida Tax Review*. 2009, 9, p. 2-6.

[192] Beale wrote in 1919 that the "*power to tax is one of the attributes of sovereignty; and the jurisdiction to exercise the power is coterminous with the bounds of the sovereign's jurisdiction*". See BEALE, Joseph H. Jurisdiction to Tax. *Harvard Law Review*. 1919, 32(6), p. 587. DOI: 10.2307/1327994. ISSN 0017811X. Available at: https://www.jstor.org/stable/1327994?origin=crossref.

[193] For a thorough discussion about sovereignty and taxation see RING, Diane M. What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State. *Virginia Journal of International Law*. 2008, 49(1), p. 1-58. ; regarding limitation of tax sovereignty see MCLURE, Charles E. Globalization, tax rules and national sovereignty. *Bulletin for International Taxation*. Amsterdam: IBFD, 2001, 55(8), p. 328-329.

[194] For reasoning behind this using the Statute of the International Court of Justice see *e.g.* SHAW, Malcolm N., ref. n. 84, p. 65-67.

[195] In general on international treaties, see *e.g.* SHAW, Malcolm N., ref. n. 84, p. 88-92.

[196] Avi-Yonah famously argues that "*a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and that it forms a significant part of international law (both treaty-based and customary)*". See AVI-YONAH, Reuven S., ref. n. 115, p. 1-21. This statement is nevertheless controversial but the latest development suggests that eliminating most cases of non-taxation and double taxation in cross-border settings are aims of the US, the UN, and the OECD (see Chapter 4).

[197] See on the MLI instrument and its influence *e.g.* AVI-YONAH, Reuven S. and Haiyan XU. A Global Treaty Override? The New OECD Multilateral Tax Treaty Instruments and Its Limits. *Michigan Journal of International Law*. 2018, 39(2), p. 155-216.

[198] See *e.g.* HELMINEN, Marjaana. *The Nordic Multilateral Tax Treaty as a Model for a Multilateral EU Tax Treaty*. Amsterdam: IBFD, 2014. ISBN 978-90-8722-221-5.

[199] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 45-80.

[200] For a brief explanation of three goals of double tax treaties see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 47-51, 371-392.

[201] HELMINEN, Marjaana, ref. n. 41, p. 32.

usually need provisions of domestic legal systems to achieve their purpose because double tax treaties do not create a new right to tax but distribute existing taxing rights between contracting states.[202] Double tax treaties do not explicitly oblige contracting states to amend their domestic law and to exercise their right to tax, but public international law obliges states to abide by their international agreements.[203] Nonetheless, states sometimes revoke treaty promises by treaty override.[204] In general, double tax treaties take precedence over domestic law in the case of a conflict between two rules.[205] Thus, some authors mention the two-fold nature of double tax treaties, *i.e.* they are a part of public international law as well as a part of domestic law.[206] Broadly speaking, double tax treaties apply (i) automatically, (ii) after consents (for instance by a parliament), or (iii) must be implemented into domestic law.[207] Most double tax treaties reflect some model tax treaty in their wording.[208] States tend to use their model tax treaties to suit their specific needs and then use these model treaties in negotiating the actual treaty.[209] However, at the beginning of drafting a national model tax treaty, states use more general model tax treaties, especially the OECD Model Tax Convention or the UN Model Tax Treaty.[210] Both of these model treaties have accompanying commentaries.[211] States choose their preferable model tax treaty based on various criteria.[212] The capital exporting countries tend to use the OECD Model Tax Convention whereas the developing countries with dominant foreign investments more often use the UN Model Tax Convention.[213]

[202] As cited by Helminen, scholars call this rule the "golden rule of tax treaty law", or as the "negative effect of tax treaties". HELMINEN, Marjaana, ref. n. 41, p. 32.

[203] For the reasoning using the VCLT and *pacta sunt servanda* and *good faith* principle see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 395. See also *e.g.* Articles 26 and 27 of the VCLT. ; HELMINEN, Marjaana, ref. n. 41, p. 32.

[204] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 146, 199-203. For a possibility of treaty override under the ATAD II see KARAIANOV, Konstantin. The ATAD II Anti-Hybrid Rules versus EU Member State Tax Treaties with Third States: Is Override Possible? *European Taxation*. 2019, 59(2/3).

[205] For a summary of reasoning behind it see *e.g.* HELMINEN, Marjaana, ref. n. 41, p. 32.

[206] HELMINEN, Marjaana, ref. n. 41, p. 32.

[207] HELMINEN, Marjaana, ref. n. 41, p. 32. The Czech Republic applies the second approach, *i.e.* the Parliament must give an approval for the treaty to become effective in domestic law. See Article 10 of the Constitutional Act No. 1/1993 Sb. (Coll.), the Constitution of the Czech Republic.

[208] For a recent empirical research on linguistic influence of model conventions, in particular the OECD Model DTC, see ASH, Elliott and Marian Y. OMRI. The Making of International Tax Law: Empirical Evidence from Natural Language Processing. *UC Irvine School of Law Research Paper Series*. 2019, 2019(02), p. 1-46. Available at: https://ssrn.com/abstract=3314310.

[209] See ASH, Elliott and Marian Y. OMRI, ref. n. 208, p. 1-46. ; OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 450.

[210] For a description of the importance of model conventions see *e.g.* LANG, Michael. *Introduction to the Law of Double Taxation Convention: 2nd edition*. Amsterdam: IBFD, 2013, p. 32-34. ISBN 978-90-8722-198-0. For historical and institutional background see ASH, Elliott and Marian Y., OMRI, ref. n. 208, p. 8-13.

[211] OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 56-60.

[212] For a thorough discussion regarding national interest in double tax treaties negotiation see DAGAN, Tsilly. The Tax Treaties Myth. *New York University Journal of International Law*. 2000, 32(4), p. 939-996.

[213] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 143-145. For a discussion about Mexico and London Models and a brief description of historical development and reasoning behind them see *e.g.* ASH, Elliott and Marian Y. OMRI, ref. n. 208, p. 8-11.

Nevertheless, the overall trend leads toward the unification of double tax treaties wording.[214] Double tax treaties and other tax treaties are international treaties under the Vienna Convention on the Law of Treaties. Hence every international tax treaty has to be interpreted in accordance with the VCLT.[215] Double tax treaties do not contain elements dealing with the establishment of residence, source, what constitutes an income, expense, and what legal entity is a taxpayer but they use these terms for their purposes to divide taxing rights between states.[216] Regarding hybrid mismatches, the key aspect of double tax treaties is that they can include provisions on exemption of some income and that they allocate taxing rights of contracting states.

Legal customs form another legally binding source of public international law.[217] In general, binding international custom consists of two elements, *i.e.* the objective element (*usus*) and the subjective element (*opnio juris* or *opinio necessitatis*).[218] The objective element denotes "*the actual practice*" of states.[219] The subjective element denotes "*how the state views its own behaviour*".[220] Overall, there are common states' practices in international taxation.[221] Nonetheless, the subjective element poses an enigma that gave rise to a great academic discussion whether legal customs in international taxation exist or not.[222] On the one hand, some authors argue in favor of legal customs in international taxation stating that states have concluded tax treaties establishing international tax regime, *i.e.* customary international law, which limits states' right to tax.[223] On the other hand, some authors argue that states "*are free to adopt any tax rules they believe further their own interests*"[224].[225] So far, it is

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214 "*We find that convergence in legal language is most clearly observed in the context of intercompany pricing, taxation of cross-border business income, and in the context of mutual agreement procedures. The lowest levels of convergence are observed in connection with certain definitional issues (such as the taxes and the geographical extent to which treaties apply), on the question on how to relieve double taxation, as well as in the context of assistance in collection of taxes*". See ASH, Elliott and Marian Y., OMRI, ref. n. 208, p. 23-24.

215 This applies also for states which are not a party to the VCLT, *e.g.* the U.S., because VCLT's provisions are a part of public international law as legal custom. See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 393. More on interpretation of double tax treaties see *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 190-197.

216 Helminen states that "*Tax treaty provisions are relevant only to the application of the treaty itself, but not in the interpretation and application of domestic law. Tax treaty definitions of different terms must be used only to solve which of the contracting states has the taxing right and to what extent. Within the limits provided by a tax treaty, each state may use its own domestic tax law definitions to classify and tax income*" HELMINEN, Marjaana, ref. n. 41, p. 33.

217 Article 38(1)(b) of the ICJ Statute. On international customs in general, see *e.g.* SHAW, Malcolm N., ref. n. 84, p. 68-88.

218 GARCÍA, Elizabeth Gil, ref. n. 85, p. 330.

219 SHAW, Malcolm N., ref. n. 84, p. 72.

220 SHAW, Malcolm N., ref. n. 84, p. 80.

221 For instance, elimination of double taxation (see Chapter 4) and using arm's length standard. For a brief summary of the discussion surrounding the arm's length standard, see *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 331-333.

222 See also Chapter 4.

223 Avi-Yonah states that the discussion uses different terms to deal with this issue and claims that the discussion around existence or non-existence of binding international tax regimes is actually a discussion about the existence or non-existence of legal customs in international taxation which is part of public international law. AVI-YONAH, Reuven S. International Tax Law as International Law. *Tax Law Review.* 2004, 57(4), p. 496-498, 501. See also AVI-YONAH, Reuven S., ref. n. 87, p. 1-12. ; AVI-YONAH, Reuven S., ref. n. 115, p. 1.

224 AVI-YONAH, Reuven S., ref. n. 115, p. 1.

unclear whether the international tax regime exists or not and if it exists what is the nature and extent of such regime, *i.e.* if the regime is established by binding legal customs or if the regime stems from "soft law" or some non-binding transnational quasi-legal order.[226]

EU law is a unique supranational legal system.[227] Its uniqueness stems from the fact that it is a separate legal system enshrined in the system of international treaties.[228] EU law is separate from domestic and public international law but interacts with both of these legal systems.[229] EU Member States enjoy broad tax sovereignty regarding direct taxation.[230] Nonetheless, EU law deals with direct taxation[231] because direct taxes can affect the establishment or functioning of the Internal Market, which is one of the main objectives of the Founding Treaties, in various ways.[232] EU law uses chiefly primary and secondary law to deal with direct taxation. Primary law consists of the Founding Treaties[233] with protocols and annexes to these treaties, the accession treaties and other treaties, legal principles of EU law, and the Charter of Fundamental Rights of the European Union.[234] Secondary law contains unilateral acts such as regulations, directives, decisions, opinions, and recommendations[235], and bilateral and multilateral acts such as agreements.[236] The principal set of

[225] See *e.g.* ROSENBLOOM, David H., ref. n. 64, p. 137-166. ; ROIN, Julie. Taxation without Coordination. *The Journal of Legal Studies*. 2002, 31(S1), p. 61-94. DOI: 10.1086/340088. ISSN 0047-2530. Available at: https://www.journals.uchicago.edu/doi/10.1086/340088. ; GRAETZ, Michael J. The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies. *Tax Law Review*. 2001, 54, p. 261-336. ; DAGAN, Tsilly, ref. n. 212. ; KANE, Mitchell. Strategy and Cooperation in National Responses to International Tax Arbitrage. *Emory Law Journal*. 2004, 53, p. 89-169.

[226] See *e.g.* ASH, Elliott and Marian Y., OMRI, ref. n. 208, p. 5. Nonetheless, García expressed an opinion recently that some international tax regime exists but it lack enforcement. GARCÍA, Elizabeth Gil, ref. n. 85, p. 333.

[227] I unfortunately cannot go into detail regarding the whole EU law on direct taxation here so for more on EU law and direct taxation see *e.g.* HELMINEN, Marjaana. *EU Tax Law - Direct Taxation 2019*. Amsterdam: IBFD, 2019. ISBN 978-90-8722-562-9. ; TRAVERSA, Edoardo, PANAYI, Christiana HJI and Werner HASLEHNER, ed. *Research Handbook on European Union Taxation Law*. Cheltenham: Edward Elgar, 2020. ISBN 978-1-78811-083-9. ; LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ed. *Introduction to European Tax Law on Direct Taxation: 5th edition*. Austria: Linde, 2018. ISBN 978-3-7073-3846-1.

[228] HELMINEN, Marjaana, ref. n. 41, p. 34. See also "*THE EEC TREATY HAS CREATED ITS OWN LEGAL SYSTEM*". CJEU, July 15, 1964, Case 6/64, *Costa v E.N.E.L.*, ECLI:EU:C:1964:66.

[229] See *e.g.* HELMINEN, Marjaana, ref. n. 227, p. 4.

[230] HELMINEN, Marjaana, ref. n. 227, p. 3.

[231] It is basically impossible to discern direct and indirect taxation but income taxation is habitually part of direct taxation; therefore, I consider international income taxation as part of the direct taxes set. This is especially important since EU law applies dividing rules to direct and indirect taxation. See THURONYI, Victor. *Comparative Tax Law*. Great Britain: Kluwer Law International, 2003, p. 54-57. ISBN 90-411-9923-3. ; THURONYI, Victor, Kim BROOKS and Barbara KOLOZS. *Comparative Tax Law*. 2nd ed. Alphen aan den Rijn, The Netherlands: Wolters Kluwer International, 2016, p. 46-48. ISBN 978-90-411-6719-4.

[232] See *e.g.* Article 3 par. 2 of the TEU ; HELMINEN, Marjaana, ref. n. 227, p. 10.

[233] Helminen enumerates amongst articles dealing with direct taxation article 4 of TEU and articles 18, 21, 45, 49, 56, 63, 107, and 115 of the TFEU.

[234] See *e.g.* ADAMCZYK Lukasz and Alicja, MAJDANSKA, Chapter 1 – The Sources of EU Law Relevant for Direct Taxation. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 2-3. ; SZUDOCZKY, Rita. *The Sources of EU Law and Their Relationships: Lessons for the Field of Taxation*. Amsterdam: IBFD, 2014, p. 15-17. ISBN 978-90-8722-294-9.

[235] Although of a non-binding nature, the recommendations also play a significant role in direct taxation because the CJEU uses from time to time recommendations for the sake of interpretation. See *e.g.* opinion of the advocate

unilateral acts consists of directives. The EU has enacted four directives dealing with substantial direct taxation so far.[237] These directives are the Parent-Subsidiary Directive on dividends[238], the Merger Directive on company reorganizations[239], the Interest-Royalty Directive[240], and the Anti-Tax Avoidance Directive (the ATAD). For the purpose of this dissertation, the PSD[241] and the ATAD[242] are the paramount directives because they contain provisions explicitly targeting hybrid mismatches.[243] Another important source of EU law in direct taxation is case law.[244] Besides primary law, secondary law, and case law, the EU uses also soft law to deal with some taxation issues.[245]

The relative legal strength of EU law norms establishes their hierarchy.[246] Primary law has the greatest legal strength. Secondary law, including directives, must therefore be enacted in accordance with primary law.[247] The directives serve to harmonize national legal orders with the same end but it is up to EU Member States to choose how it will achieve this end as long as it is achieved by law, *i.e.* using a legally binding solution. The specificity of directives in EU tax law arises out of the Article 115 TFEU, which gives the Council the right to issue directives approximating laws, regulations or administrative provisions of the Member States that directly affect the establishment or functioning of the Internal Market.[248]

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general in CJEU, February 14, 1995, *Schumacker*. ECLI:EU:C:1994:391, par 73-75. For a summary of the case see HELMINEN, Marjaana, ref. n. 227, p. 26.

[236] See *e.g.* HELMINEN, Marjaana, ref. n. 227, p. 21-26. ; SZUDOCZKY, Rita, ref. n. 234, p. 18-22.

[237] The legal basis for the EU to enact these directives is Article 115 of TFEU. This article enables the Council to issue a directive to approximate legal orders of EU Member States but requires unanimous vote of all EU Member States because of the specific nature of states' tax sovereignty. The unanimity requirement can be avoided by procedures based on Article 116 of TFEU, and Article 20 TEU in connection with articles 326-334 TFEU (enhanced cooperation), but these procedures has not been used in direct taxation yet. HELMINEN, Marjaana, ref. n. 227, p. 21-22.

[238] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[239] Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.

[240] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

[241] Article 4(1)(a) of the PSD.

[242] Articles 9, 9a, and 9b of the ATAD.

[243] The CCCTB proposal also contains provisions tackling hybrid mismatches but the proposal still has not been approved. See *e.g.* Article 64 of the Proposal for a COUNCIL DIRECTIVE on a Common Corporate Tax Base Article COM(2016) 685 final ; Article 74 of the Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB) COM(2016) 683 final.

[244] SZUDOCZKY, Rita, ref. n. 234, p. 26-28.

[245] SZUDOCZKY, Rita, ref. n. 234, p. 23-25.

[246] For a general description of hierarchy of EU law legal norms see *e.g.* Hierarchy of Norms. CRAIG, Paul and Gráinne DE BÚRCA. *EU Law: Text, Cases, and Materials. Sixth edition*. Oxford: Oxford University Press, [2016], p. 110-123. ISBN 978-0198714927.

[247] See Article 288 of the TFEU.

[248] Art. 115 of the TFEU states that "*Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market*".

Three important limitations of Article 115 are that (i) the positive harmonization (approximation) must use a directive, as opposed to, *e.g.* regulation, (ii) all EU Member States must consent with the directive, and (iii) the directive must subject to approximation only laws, regulations or administrative provisions of the Member States that directly affect the Internal Market.

The directive requirement has its pros and cons. The positive feature of directives is that EU Member States may decide what means they use to implement a directive. The negative feature of directives in the area of direct taxation is that they can create mismatches due to different transpositions of definitions and rules.[249] The specific character of directives dwells in the fact that Member states are obliged to implement a directive into their domestic laws.[250] However, Member states may implement them by means which EU Member States consider to be the best tool for particular implementation as long as the solution is consistent with the purpose of the directive.[251] In the case of an incorrect transposition, a directive can be directly applicable.[252] The directives concerning direct taxation usually set only minimum requirements, so the extent of advantages given to taxpayers under domestic laws may be broader than under a transposed directive and still within the frame of directive goal and purpose.[253] Possible conflicts of domestic law and directive provisions may be solved by the Court of Justice of the European Union which is competent to ensure the uniform application of directive provisions.[254]

The second requirement states that no EU Member State can veto the directive. Some consider this to be an Achilles' heel of Article 115 of the TFEU because it is difficult to persuade some EU Member States using "*benevolent*" direct tax policy not to use their right to veto directives trying to improve the compliance of taxpayers or trying to protect the corporate tax base.[255]

The third requirement is necessary because EU Member States have not vested a general power to lay down direct taxation to the EU and the EU has the power to deal with direct taxation only to the extent it impedes the establishment and functioning of the internal market.[256]

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[249] Such difference can arise even because of a different translation of directives. See *e.g.* FIBBE, Gijs K. The different translations of the term 'company' in the Merger Directive and the Parent Subsidiary Directive: a Babylonian confusion of tongues? *EC Tax Review*. Wolters Kluwer, 2006, 15(2), p. 95-102.

[250] HELMINEN, Marjaana, ref. n. 41, p. 34-35.

[251] HELMINEN, Marjaana, ref. n. 41, p. 35.

[252] ADAMCZYK Lukasz and Alicja, MAJDANSKA, Chapter 1 – The Sources of EU Law Relevant for Direct Taxation. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 5-7.

[253] HELMINEN, Marjaana, ref. n. 41, p. 36.

[254] HELMINEN, Marjaana, ref. n. 41, p. 36.

[255] DOURADO, Ana Paula. The Commission Proposal to Replace Unanimity with a Qualified Majority in the Case of Tax Matters. *Intertax*. Wolters Kluwer, 2019, 47(4), p. 341-344. For a recent development in the discussion on the unanimity against the qualified majority see ENGLISCH, Joachim. Article 116 TFEU – The Nuclear Option for Qualified Majority Tax Harmonization? *EC Tax Review*. Wolters Kluwer, 2020, 29(2), p. 58-61.

[256] HELMINEN, Marjaana, ref. n. 227, p. 13.

To sum up, to deal with taxing a cross-border income, it is necessary to consider rules of domestic law (national legal systems), public international law (the international legal system), and EU law (the supranational legal system) to deal further with the issue of hybrid mismatches which is connected to multiple (or no) taxation.

2.4. Relationships of Legal Systems in International Taxation

So far I have shown which elements of legal systems (residence, source, income definition, exemption and deduction definition, and taxpayer definition) and what legal systems (national, international, and supranational) are relevant for international taxation from the perspective of EU Member States. Now the question is: "*What if there is a conflict between these legal systems and their rules?*" In other words, what is the relationship between these legal systems and rules containing elements necessary for establishing proper taxation?

Possible relationships of legal systems from the EU Member States perspective are the following:

- two or more domestic legal systems;
- domestic legal system and public international law;
- domestic legal system and EU law;
- public international law and EU law.[257]

In general, states can enact their tax laws regardless of other states' tax laws. EU Member States however have to enact their laws in accordance with duties they have toward public international law[258] and EU law[259]. EU Member States have a duty not to breach EU law and, regarding directives, to implement directives by means that achieve the directives' goals.[260]

As regards the relationship of two or more domestic legal systems, their interaction without any coordination can lead to a conflict of characterization.[261] States often use unilateral rules to deal with these situations, but the rules may still result in conflict, leading to double taxation or non-taxation (see Chapter 4),[262] because states do not have any obligation to reflect how other states characterize certain taxpayers or items of income.[263] Since this outcome can be unsatisfactory for states, they use international double tax treaties to coordinate their domestic legal systems. The double tax treaty then creates its own legal system which interacts with the domestic legal system of

[257] HELMINEN, Marjaana, ref. n. 41, p. 31-39.
[258] See *e.g.* LANG, Michael, ref. n. 210, p. 23-24.
[259] See *e.g.* HELMINEN, Marjaana, ref. n. 227, p. 6.
[260] See Chapter 8 for a detailed discussion on implementation of directives.
[261] HELMINEN, Marjaana, ref. n. 41, p. 31.
[262] HELMINEN, Marjaana, ref. n. 41, p. 31-32.
[263] HELMINEN, Marjaana, ref. n. 41, p. 31.

the contracting state.[264] The possible interaction among the domestic legal system and tax treaty law depends on how a particular state grasps international tax treaties in its law.[265] Based on the *pacta sunt servanda* and good faith principles, double tax treaty provisions take precedence over domestic tax law provisions.[266] Thus, tax treaty provisions take precedence over domestic tax law provisions unless a state changes domestic law and thereby overrides the double tax treaty rule.[267] As regards the relationship between definitions in double tax treaties, for example, the OECD DTC Model either defines some terms autonomously[268] or does not define at all.[269] The OECD DTC Model however contains the interpretation rule stating with some exceptions that "*any term not defined therein* (...) *shall have the meaning it has at that time under the law of that State for the purposes of the taxes to which the Convention applies*".[270] Domestic law is then basically unlimited in what the term contains and a mismatch in interpretation may appear because both domestic laws can use a different definition of one term and expect the same interpretation from the other contracting state.[271] To deal with this issue, the OECD has amended the Commentary to the OECD DTC Model.[272]

As regards the relationship between a domestic legal system and EU law, possible interactions between EU law and domestic legal systems are many. The primacy of EU law governs the relationship of EU Member State's domestic law and EU law.[273] EU Member State's domestic law thus must avoid infringing EU law and EU law generally takes precedence over EU Member State's domestic law.[274] Nevertheless, a rule of thumb is that EU Member States must abide by EU law, its rules, and principles. The principles of supremacy[275], direct effect[276], and direct application[277]

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[264] HELMINEN, Marjaana, ref. n. 41, p. 32, 39.

[265] For example, if the state uses monist or dualistic approach toward double tax treaties. In relation to double tax treaties see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 439-440.

[266] HELMINEN, Marjaana, ref. n. 41, p. 32.

[267] "*The effect of tax treaties on the tax systems of contracting states is founded on the assumption that contracting states levy taxes based on their own domestic laws. Thus, it is not the role of a tax treaty to impose or allocate taxes. Instead, tax treaties have a limiting effect on the applicability of the domestic laws of contracting states. As a consequence, tax treaties preclude the application of domestic rules in certain situations, or they require that a contracting state grants a tax credit for taxes levied by the other state*". OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 440.

[268] See *e.g.* Articles 3, 4, 5, 6, 10, 11, and 12 of the OECD DTC Model. Article 3(1) defines terms such as person, company, enterprise, and national; Article 4 defines a resident of a contracting state; Article 5 defines permanent establishment; Article 6(2) defines immovable property; Article 10(3) defines dividends; Article 11(3) defines interest; Article 12(2) defines royalties.

[269] On the interpretation of terms in double tax treaties including an application of the MLI see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 393-438.

[270] Article 3(2) of the OECD DTC Model. On the application issues and solutions see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 442-445.

[271] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 444. ; HELMINEN, Marjaana, ref. n. 41, p. 33. ; OECD, ref. n. 66, p. 376.

[272] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 445.

[273] HELMINEN, Marjaana, ref. n. 227, p. 5.

[274] HELMINEN, Marjaana, ref. n. 227, p. 3, 6.

[275] CJEU, July 15, 1964, Case 6/64, *Costa v E.N.E.L.*, ECLI:EU:C:1964:66.

[276] CJEU, February 5, 1963, Case 26/62, *Van Gend en Loos*, ECLI:EU:C:1963:1.

[277] CJEU, March 9, 1978, Case 106/77, *Simmenthal*, ECLI:EU:C:1978:49, par. 21.

of EU law are fundamental for solving possible conflicts.[278] Therefore, EU Member State must enact, interpret, and apply tax rules in accordance with EU law.

As regards the relationship between public international law and EU law EU law precedes domestic law from the perspective of EU Member States' law but not from the perspective of third states, *i.e.* non-EU Member States.[279] Nonetheless, EU Member States cannot conclude an international treaty with a third country that would breach EU law.[280] Similarly, in the case an international treaty between EU Member State and a third country becomes illicit under EU law, the EU Member State must renegotiate such an international treaty.[281] EU Member States which concluded tax treaty with a third state (non-EU Member state) is thus obliged to apply its domestic tax laws in accordance with the EU law but the EU Member state is also obliged to apply provisions of the tax treaty under the Vienna Convention on the Law of Treaties. In the case the tax treaty provisions are in conflict with the EU law an EU Member State must try to renegotiate the tax treaty otherwise the EU Member State might breach EU law or a tax treaty provisions under public international law.[282]

2.5. Tax Law Classification and Possibility of Mismatches

The classification of economic reality for tax law purposes constitutes the heart of tax law. The need to classify the whole economic reality for tax law is one of the main drivers of complexity in tax law in general and in income tax law in particular.[283] Legislators divide economic reality into categories. This division makes it easier to design income tax around fewer sets of taxpayers, items of income, and other variables, such as criteria for the classification of ownership. And the correct characterization of the item of income is crucial for dealing properly with taxation because an inappropriate characterization may lead to overstatement or understatement of the tax duty. The complexity rises when adding EU law and public international law into the equation. All these legal systems are separate from each other but they also affect each other. Every definition in one legal system is independent of a definition for other legal system's purposes.[284] Hence, these legal systems can classify a particular item of economic reality in cross-border settings (*e.g.* legal entity, payment, ownership) in a different manner which creates a classification mismatch.

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[278] See also HELMINEN, Marjaana, ref. n. 227, p. 8-9.

[279] HELMINEN, Marjaana, ref. n. 41, p. 34-37.

[280] VOGEL, Klaus, Daniel GUTMANN and Ana Paula DOURADO. Tax treaties between Member States and Third States: 'reciprocity' in bilateral tax treaties and non-discrimination in EC law. *EC Tax Review*. Wolters Kluwer, 2006, 15(2), p. 83.

[281] HELMINEN, Marjaana, ref. n. 227, p. 6, 29.

[282] HELMINEN, Marjaana, ref. n. 41, p. 37-38.

[283] BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 12-17.

[284] HELMINEN, Marjaana, ref. n. 41, p. 39-42.

Mismatches in classifications can constitute either *a problem of classification* (a substitution problem) or *a classification conflict*.[285] The problem of classification arises between two domestic legal systems in a case these systems classify one element for income tax law purposes differently.[286] Scholars do not consider these mismatches in domestic tax characterization as conflicts because there is actually no conflict of legal rules because even though the tax characterization is done correctly, legislators may decide to divide the economic reality in contrasting ways[287] without further coordination, *e.g.* in a form of harmonization under EU law.[288] The classification conflict arises if two states classify one element differently for purposes of an international treaty concluded by these two states.[289] This conflict can lead either to double taxation (a positive classification conflict) or to double non-taxation (a negative classification conflict).[290] Double taxation and double non-taxation outcomes are possible in no tax treaty scenario as well as in double tax treaty scenario where a mismatch in interpretation or application of a double tax treaty. Similarly, a mismatch may arise between EU Member States when these states apply EU directives differently.[291]

As I have described above, any international tax treaty defines terms for its own purposes, does not bind national tax law to amend statutes, and international tax treaties are usually not self-executing. However, domestic law must be in accordance with the international treaty based on public international law norms. The issue is that treaty definitions and definitions under national tax law may divide. Thus, the definitions of two countries may be different and a definition concluded in the international tax treaty may be different, too. This means that three different definitions may exist under certain circumstances.[292]

Helminen analyzes[293] possible relationships between domestic and international tax treaties regarding the definition of dividend, but this analysis can be applied to other terms constituting a definition of other elements as well. The treaty definition can be the same, broader or narrower than the definition of domestic tax law purposes. The first option is the ideal one. The second

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[285] Helminen summarizes the academic literature stating that the classification conflict term has a broad sense and strict sense. In broad sense, the classification conflict includes "*any inconsistent subsumption of a fact, form or term under two different legal systems of international tax law*" whereas in strict sense the term classification conflict "*includes only conflicts in tax treaty classification or EU tax law classification*". HELMINEN, Marjaana, ref. n. 41, p. 40 and 41. Helminen also deals with a difference between classification and interpretation writing that classification conflict includes "*the problem of what definition of several possible definitions is to be applied*" whereas interpretation "*involves the question of what items are included under the selected definition*". HELMINEN, Marjaana, ref. n. 41, p. 41. However, these two terms are closely connected. HELMINEN, Marjaana, ref. n. 41, p. 42.

[286] HELMINEN, Marjaana, ref. n. 41, p. 39.

[287] For some reasons why countries have different tax rules see RING, Diane M. One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage. *Boston College Law Review*. 2002, 44(1), p. 88-89.

[288] HELMINEN, Marjaana, ref. n. 41, p. 39.

[289] HELMINEN, Marjaana, ref. n. 41, p. 39-40.

[290] HELMINEN, Marjaana, ref. n. 41, p. 40.

[291] For a brief discussion regarding interpretation conflicts see HELMINEN, Marjaana, ref. n. 41, p. 41.

[292] HELMINEN, Marjaana, ref. n. 41, p. 32-33.

[293] HELMINEN, Marjaana, ref. n. 41, p. 32-34.

option means that the definition under the treaty is broader but narrower under the national definition, so the actual taxation is not affected but probably some income may be untaxed. The third option means that domestic law contains a broader definition than an international treaty. In such instance, the taxation of such income may be affected, *i.e.* a treaty may limit a state in its power to tax. The definition can also be concurrently broader and narrower.

2.6. Common Solutions to Conflicts of Tax Classification

Unresolved classification conflicts may lead to double taxation or non-taxation of income, which is usually an unwanted outcome from the tax policy perspective of contracting states.[294] State authorities can try to deal with this situation differently depending primarily on the tax policy preferences of contracting states and the relationship of legal systems involved in such a conflict. [295] The classification conflict may be solved by competent authorities or only outcomes themselves of this conflict may be eliminated without dealing with the classification conflict itself.[296]

Tax treaties may eliminate the unwanted outcomes of a classification conflict, *e.g.* by means of a *subject-to-tax clause* or *credit method* (using this method instead of the *exemption method*[297]).[298] In the case parties to a tax treaty want to solve the classification conflict beforehand, they may incorporate in a tax treaty specific rules which have either the purpose to prevent the occurrence of a classification conflict or to give a guideline how to solve it in the case the conflict has already emerged.[299]

The most straightforward solution to a classification conflict is to define a relevant term in a tax treaty itself. For example, the OECD Model DTC explicitly defines the term "*dividend*".[300] When the term is defined in the tax treaty, there is in fact no classification problem, unless the definition itself contains undefined terms that need further interpretation. [301]

A common practice is to lay down rules of interpretation in tax treaties articles in order to solve possible classification conflicts.[302] Under the general interpretation rule laid down in the OECD DTC Model, the undefined term of the tax treaty should be interpreted consistently with the

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[294] See Chapter 4.

[295] There is no supranational authority which could solve it other than states authorities (with an exception of the CJEU). HELMINEN, Marjaana, ref. n. 41, p. 42-43.

[296] HELMINEN, Marjaana, ref. n. 41, p. 43.

[297] See *e.g.* Article 23B of the OECT Model DTC.

[298] HELMINEN, Marjaana, ref. n. 41, p. 43.

[299] Regarding the interpretation of double tax treaties see *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 79, p. 393-468. ; OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 190-203. ; ARNOLD, Brian J. *International Tax Primer*. United Kingdom: Wolters Kluwer International, 2016, p. 147-151. ISBN 978-90-411-5975-5. ; LANG, Michael, ref. n. 210, p. 41-63. ; VOGEL, Klaus. Double Tax Treaties and Their Interpretation. *International Tax & Business Lawyer*. 1986, 4(1), p. 1-84.

[300] HELMINEN, Marjaana, ref. n. 41, p. 46.

[301] HELMINEN, Marjaana, ref. n. 41, p. 46.

[302] HELMINEN, Marjaana, ref. n. 41, p. 47-49.

domestic tax law applied by a contracting state.[303] However, some articles dealing with particular types of income contain their own provisions dealing with interpretation.[304] Such provision is a special rule in relation to the general interpretation rule and thus takes precedence over the general rule.

Double taxation relief provisions do not solve the classification problem itself and only eliminate the unwanted outcome of such a conflict. Under these articles of the OECD DTC Model, the contracting state that is the residence state of the income recipient is obliged to apply the exemption or credit method to the income tax imposed by the other state, *i.e.* the source state. The amount which is credited against the income tax equals to the tax imposed on the same income item by that other contracting state according to the tax treaty provisions. The condition that the state from which the income is derived imposed a tax in accordance with tax treaty rules is crucial because if the tax is imposed in conflict with the tax treaty the state of residence do not have the obligation to allow for the credit of foreign tax or for the exemption under mentioned articles of the OECD DTC Model.

Mutual agreement procedure under the OECD DTC Model gives taxpayers the possibility to initiate negotiation when "*actions of contracting states result in taxation that is not in accordance with the provisions of the tax treaty*"[305]. Mutual agreement procedure negotiations are conducted by the competent authorities of contracting states with the purpose of solving classification conflicts. However, contracting states are currently not obliged to arrive at the conclusion that eliminates double taxation unless the particular tax treaty includes a possibility of compulsory arbitration.[306]

When a tax treaty does not involve any explicit rule how to solve a classification conflict, four approaches to eliminating the conflict are commonly considered *i.e.* (i) lex fori classification, (ii) source state classification, (iii) classification of a state of a residence of an income recipient, and (iv) autonomous classification.[307] It means that set of rules relevant for solving the conflict is chosen on the basis of one of these four criteria. Hence countries use coordination rules to enact these approaches into their domestic tax law.

2.7. A Is A… Or Is It? Tax Theory, Tax Policy, and Tax Law and Their Context

For the clarity of subsequent discussion, I find it useful to define three possible contexts in which a term can be used when dealing with international taxation in practice and theory.

[303] HELMINEN, Marjaana, ref. n. 41, p. 47-48.
[304] See *e.g.* Article 10 par. 3 of the OECD Model DTC.
[305] Article 25 of the OECD Model DTC.
[306] HELMINEN, Marjaana, ref. n. 41, p. 49-50.
[307] HELMINEN, Marjaana, ref. n. 41, p. 44 and following.

For the purposes of the dissertation, I define tax theory as a body of knowledge produced by academics and practitioners while joining a general debate on the topic of taxation.

For the purposes of the dissertation, tax policy "*refers to the approach of a government to the design and implementation of its tax system, including the tax mix or choice of different forms of taxation as well as their individual design features. It entails decisions also about the goals of the tax system and the priorities to be given to the different criteria* (…) *such as equity and efficiency, which are not always compatible. Choices need to be made also about the overall objective of the tax system and social and economic priorities that the tax system needs to support*"[308] Thus, the tax policy discussion is a discussion about what tax system should look like under the constraints of several goals which are often competing. This means that tax policy concerns discussion about how tax design should look and how to implement tax decisions in tax law.[309]

For the purposes of the dissertation, tax law[310] is a set of tax legal norms. The goal of tax law is to effectively implement tax policy.[311]

All of these fields serve specific purposes and are intertwined. They create a context for tax documents, discussions, interpretation, and application. Since in taxation economics blends with law even more than in other areas of law, it is paramount to always make sure what the current context is.

2.8. Summary and Conclusion

To sum up, I have shown in this chapter that countries have to establish their jurisdiction over cross-border income. To establish such jurisdiction, countries use rules containing elements that define the necessary nexus of such income to the country's jurisdiction. Domestic tax law primarily establishes these elements but international and supranational legal systems also play a key role in international taxation. Therefore, proper legal analysis of cross-border taxation has to concern all of these legal systems. To proceed with such analysis, I have displayed that these legal systems are separate and define terms for their own purposes. However, these legal systems are also entwined and affect each other. I have also illustrated that differences between domestic tax laws can lead to classification mismatches which can create double taxation or non-taxation situations. I have briefly discussed common solutions to these classification conflicts and differences between tax theory, tax policy and tax law to avoid possible confusion in the following discussion.

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[308] OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 16.

[309] Among other things, tax theory and tax policy discussions and tax policy decisions are important for proper tax law interpretation because, for example, the question of the abuse of law usually depends on finding the goal of the legal norm, which is nearly impossible without taking tax policy into consideration.

[310] THURONYI, Victor, ref. n. 134, p. 60-62.

[311] See *e.g.* BROOKS, Neil. An Overview. EDGAR, Tim, Arthur COCKFIELD and Martha O'BRIEN, ed. *The Logic, Policy and Politics of Tax Law: 15th Edition*. Carswell, 2015, p. 1-80. ISBN 9780779866953.

3. Prologue: Hybrid Mismatches and their Examples

3.1. Introduction

In this chapter, I want to show what hybrid mismatches are, what their model examples are, and what outcomes hybrid mismatches can create. I believe that there are several reasons to include this description in the dissertation. Firstly, the literature on hybrid mismatches is patchy. Authors often include discussion of hybrid mismatches in discussions of international taxation, in general, or tax arbitration, in particular, or focus only on a specific type of hybrid mismatches (*e.g.* hybrid entities, hybrid financial instruments). But a coherent discussion in one work is currently missing. Secondly, no Czech author has yet written about hybrid mismatches to a considerable extent. Lastly, the general introduction establishes a foundation for the subsequent chapters, which shows why hybrid mismatches pose an issue from a tax policy perspective and what countries can do to prevent them. I use examples of hybrid mismatches outcomes in subsequent chapters to argue that dealing with the core issue, the different tax characterization, is more effective than dealing with the outcomes that are not desired from the tax policy perspective as linking rules do. The aim of this chapter is thus to describe and analyze hybrid mismatches in general so I can further address the solutions proposed to tackle them.

The chapter deals first with the terms "*hybrid mismatch*" and "*hybrid mismatch arrangement*". Then I shift the focus to subsets of hybrid mismatches that are the subject of this dissertation, *i.e.* hybrid entities, hybrid financial instruments, and hybrid transfers. As a small addition outside of the dissertation's scope, I have included a brief discussion of branch mismatches (permanent establishments) so the reader has a broader picture of the variety of mismatches covered by the BEPS Action 2. I have also decided to briefly discuss imported hybrid mismatches because they depict the limitations of some hybrid mismatches solutions that I discuss in the following chapters and show some usefulness of linking rules.

As Cicero says, every rational approach to instruction on any subject ought to begin with a definition.[312] Following his example, each part starts with the definition of the particular set of hybrid mismatches from the perspective of tax theory. Then, each part includes model examples with their outcomes, definitions for the OECD tax policy purposes (stemming from the BEPS Project Action 2), and the legal definition of the hybrid mismatch under EU law (the ATAD and the PSD).

[312] „*For every rational approach to instruction on any subject ought to begin with a definition, to ensure that people know what the topic under discussion is.*" Book 1. CICERO and P. G. WALSH. *On Obligations: De Officiis*. Oxford: Oxford University Press, 2000, p. 5. ISBN 978-0199540716.

3.2. Hybrid Mismatches, Hybrid Arrangements, or Hybrid Mismatch Arrangements?

The definition of hybrid mismatches and hybrid mismatch arrangements is by no means settled. Authors use hybrid mismatches definitions for divergent purposes, and it is apparently impossible to come up with one unifying definition for tax theory, tax policy, and tax law purposes. The definition for tax theory purposes is descriptive. The definition for the OECD BEPS Action 2 tax policy reasons is on one hand used widely but on the other hand criticized by academics. The definition for EU tax law purposes stems from the OECD BEPS Action 2 tax policy purposes, *i.e.* the Action 2 final report.

3.2.1 Tax Theory Definition of Hybrid Mismatches

From the tax theory perspective, hybrid mismatch definition is not settled and consistent. Authors use terms such as *hybrid mismatches*, *mismatches arrangements*, and *hybrid mismatch arrangements* and emphasize various characteristics of these situations.

The IBFD Tax Glossary defines hybrid mismatches as "*arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries. Hybrid mismatch arrangements often lead to "double non-taxation" or may alternatively lead to a tax deferral that, if maintained over several years, is economically similar to double non-taxation*". The IBFD Tax Glossary thus uses the same definition as the OECD BEPS Project Action 2.[313] Therefore, this definition should not be immediately accepted without further consideration as a definition for tax theory purposes because the definition serves primarily the OECD tax policy purposes.[314]

Arnold broadly defines hybrid arrangements as "*situations in which two countries take different and inconsistent positions with respect to the tax treatment of some aspect of an arrangement*".[315] This definition is broad and includes many kinds of mismatches. The definition does not explain why the term includes the word *hybrid.* Also, the inconsistent position can appear between more than two countries.

Helminen defines hybrid mismatches as "*the consequence of the differences in the characterization of payments on financial instruments or of entities under the tax systems of two jurisdictions*"[316] which may lead to

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[313] See below.

[314] See HARRIS, Peter. Neutralizing Effects of Hybrid Mismatch Arrangements: Papers on Selected Topics in Protecting the Tax Base of Developing Countries. *UN* [online]. New York: United Nations, 2014, September 2014 [cit. 2020-07-29]. Available at: https://www.un.org/esa/ffd///wp-content/uploads/2014/09/20140923_Paper_-HybridMismatchArrangements.pdf.

[315] ARNOLD, Brian J. *International tax primer.* Alphen aan den Rijn: Wolters Kluwer, 2019, p. 206. ISBN 978-94-035-0282-3.

[316] HELMINEN, Marjaana, ref. n. 227, p. 280.

DD and D/NI outcomes, *i.e.* non-taxation, or to situations of double taxation.[317] Thus, Helminen emphasizes the consequence whereas Arnold has a broader view of any situation regardless of its outcome. Nevertheless, Helminen uses the definition to explain reasons for enacting the ATAD that deals with outcomes of hybrid mismatches so her narrower view is in accordance with the purpose of her text.[318]

Oats and others use the term *hybrid arrangement* in a similar way as Arnold does; they do not define the term by a general definition but state that hybrid arrangements are either hybrid entities or debt-equity hybrid financial instruments.[319]

Apparently, authors use the definition of hybrid mismatches according to what is the purpose of their particular discussion. Thus, a general widely accepted theoretical definition of hybrid mismatches is absent. However, scholars and tax practitioners mostly need to deal with practical definitions for tax policy and tax law reasons, so the absence of the general definition does not have to be troubling. All in all, tax theory uses three terms to denote situations encompassing hybrid entities, hybrid financial instruments, and hybrid transfers, *i.e.* hybrid mismatches, hybrid arrangements, and hybrid mismatch arrangements. Grammatically speaking, the term hybrid mismatches should entail the broadest set of situations because it lacks the requirement of an arrangement. The term hybrid arrangements should involve a situation where an arrangement takes place and it contains some hybridity, *e.g.* hybrid financial instrument, hybrid transfer.[320] The term hybrid mismatch arrangement reflects the OECD BEPS Project Action 2 definition (see below) and should encompass situations where an arrangement is in place which leads to a mismatch due to the hybridity of this mismatch. To sum up, these definitions logically emphasize two (hybrid mismatches) or three (hybrid mismatch arrangements) elements of cross-border situations containing hybrid entities, hybrid financial instruments, and hybrid transfers. These elements are (i) hybridity, (ii) mismatch, and (iii) arrangement.

Harris explains these three terms when discussing hybrid mismatch arrangements in general and specifically in regard to the OECD BEPS Action 2.[321] According to him, the "*'hybrid' part of the phrase means that, in a particular case (taken to be an 'arrangement'), two countries do not agree on the classification or characterisation of some feature of the arrangement that is fundamental for income tax purposes*".[322] Regarding

[317] HELMINEN, Marjaana, ref. n. 41, p. 32.
[318] The ATAD uses linking rules to deal with hybrid mismatches. It means that rules link outcomes of hybrid mismatches to deal with non-taxation. Therefore, Parada calls this approach a consequentialist one. See *e.g.* PARADA, Leopoldo, ref. n. 29, p. 977-980. See also *e.g.* See COOPER, Graeme S., ref. n. 353, p. 339.
[319] OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 358.
[320] Harris argues similarly stating that not all hybrid arrangements lead to a mismatch. See HARRIS, Peter, ref. n. 314, p. 3.
[321] HARRIS, Peter, ref. n. 314, p. 3 and following.
[322] HARRIS, Peter, ref. n. 314, p. 3.

the mismatch, Harris writes that the "*'mismatch' feature is different and suggests that the different ways in which two countries view the particular arrangement produce some sort of inconsistent outcome when looked at in the whole*". [323] The mismatch can be either beneficial or harmful to taxpayer.[324] The term arrangement is either a transaction or series of transactions, without a normative assessment, or a transaction or series of transactions having the aim to lower tax burden.[325]

From the definitions I have described above, I infer tax theory definition of hybrid mismatch arrangement. This arrangement is an arrangement which two (or more) jurisdictions classify differently for tax purposes and this difference leads to an inconsistent outcome for their tax purposes. An Important feature of this definition is that it does not provide any normative iassessment whether states should prevent this outcome or not.

3.2.2 OECD Tax Policy Definition of Hybrid Mismatch Arrangements in the BEPS Project Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

The OECD BEPS Action 2 Final Report from 2015 does not define the term hybrid mismatch arrangement.[326] Executive summary of this report includes a closer reference to hybrid mismatch arrangements which states that hybrid mismatch arrangements "*exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral*".[327] This description is obviously not a proper definition.[328] The OECD stipulates the definition in the OECD BEPS Action 2 Deliverables from 2014 which defines hybrid mismatch arrangement as "*an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement*".[329] The report also describes four conditions[330] for the hybrid mismatch arrangement to take place.[331] First, there must be an arrangement[332]. Second, the arrangement must result in a mismatch in the tax treatment[333] of

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[323] HARRIS, Peter, ref. n. 314, p. 3.

[324] HARRIS, Peter. Neutralizing effects of hybrid mismatch arrangements. TREPELKOV, Alexander, Harry TONINO and Dominika HALKA. *United Nations Handbook on Selected Issues in: Protecting the Tax Base of Developing Countries*. 2nd ed. New York: United Nations, 2017, p. 217.

[325] However the normative assessment stems from the OECD tax policy assessment. See *e.g.* DANICZ, Linda. Purpose of and Policy Considerations for Implementing Hybrid Mismatch Rules. LANG, Michael, Erik PINETZ and Erich SCHAFFER, ed. *Limiting Base Erosion*. Austria: Linde, 2017, p. 7. ISBN 978-3-7073-3758-7.

[326] See OECD, ref. n. 20.

[327] See OECD, ref. n. 20, p. 11.

[328] For argumentation based on HARRIS, Peter, ref. n. 324, see *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 140.

[329] OECD. *Neutralising the Effects of Hybrid Mismatch Arrangements*. Paris: OECD Publishing, 2014, p. 29. OECD/G20 Base Erosion and Profit Shifting Project. ISBN 978-92-64-21881-9.

[330] Some authors mention only three because they apparently treat the first "arrangement" condition as an implicit one. See *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 141.

[331] OECD, ref. n. 329, p. 29-31.

[332] According to BEPS Action 2 Recommendation 12 the term arrangement refers to "*an agreement, contract, scheme, plan, or understanding, whether enforceable or not, including all steps and transactions by which it is carried into effect. An arrangement may be*

a payment.[334] Thirdly, the arrangement must contain a hybrid element that causes a mismatch in tax outcomes.[335] Lastly, the mismatch in tax outcomes must lower the aggregate tax paid by the parties to the arrangement.[336] This shows that hybrid mismatch arrangement has to contain four elements, *i.e.* arrangement, hybrid element, payment, and DD or D/NI outcome, so the Action 2 linking rules apply.[337]

The OECD tax policy definition of hybrid mismatch arrangements is thereby narrower than tax theory definition of hybrid mismatches because the OECD tax policy definition demands payment, mismatch, and DD or D/NI outcome elements.[338] The OECD BEPS Action 2 thus deals only with hybrid mismatches that lead to lowering of the overall tax burden[339] and does not deal with hybrid mismatches that lead to multiple taxation. Moreover, the OECD BEPS Action 2 deals only with arrangements between taxpayers who belong to the same group and the OECD so narrows the application scope of the recommended solution even further.[340] This scope narrowing illustrates the fact that the Action 2 deals only with non-taxation arising due to the use of hybrid entities, debt-equity hybrid financial instruments, and hybrid transfers and it shows that the OECD focuses only on establishing single taxation in some non-taxation scenarios but does not in multiple taxation scenarios in relation to hybrid mismatch arrangements (see Chapter 4).

part of a wider arrangement, it may be a single arrangement, or it may be comprised of a number of arrangements". See OECD, ref. n. 20, p. 165.

333 Or the arrangement results in difference in the tax treatment. HARRIS, Peter, ref. n. 324, p. 240.

334 The BEPS Action 2 Recommendation 12 states that the term payment "*includes any amount capable of being paid including (but not limited to) a distribution, credit, debit, accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties*". See OECD, ref. n. 20, p. 165. This definition might be useful for interpretation of the CITA because Section 23h of the CITA use the term *payment* which is an EU term because it stems from the Article 2(9) of the ATAD. The ATAD II however enumerates in Recital 28 that "*In implementing this Directive, Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law*". Therefore, the term payment from Action 2 Recommendation 12 can be used for an interpretation of both the ATAD and the CITA as regards hybrid mismatch arrangements. For the discussion about hybrid mismatches including a payment see *e.g.* HARRIS, Peter, ref. n. 324, p. 223-230.

335 See OECD, ref. n. 329, p. 30-31. ; OECD, ref. n. 20, p. 18.

336 See OECD, ref. n. 329, p. 31. Similarly, see *e.g.* DE BOER, Reinout and Otto MARRES, ref. n. 339, p. 20. See also COOPER, Graeme S., ref. n. 353, p. 339, stating that the OECD defines the term hybrid mismatch arrangements by the effect of such arrangements, *i.e.* double non-taxation.

337 For a thorough discussion about the definition of hybrid mismatch arrangements see *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 140-147. ; PARADA, Leopoldo, ref. n. 8, p. 279-298.

338 See also Cooper stating that the OECD BEPS Action 2 does not aim to deal with all mismatches but deals "*with only a few key issues in the current international tax order*". See COOPER, Graeme S., ref. n. 353, p. 336.

339 See *e.g.* DE BOER, Reinout and Otto MARRES. BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements. *Intertax*. Wolters Kluwer, 2015, 43(1), p. 20.

340 See BEPS Action 2 Recommendation 11, OECD, ref. n. 20, p. 164. See also *e.g.* DE BOER, Reinout and Otto MARRES, ref. n. 339, p. 18-19. ; MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 166-171. ; PEETERS, Bart and Lars VANNESTE. The Hybrid Financial Instruments: The Effects of the OECD BEPS Action 2 Report and the ATAD. *Intertax*. Wolters Kluwer International, 2020, 48(1), p. 19-22.

The OECD states that hybrid mismatch arrangements include hybrid element which leads to a mismatching application of tax rules which generate non-taxation outcomes.[341] Parada analyzes the term[342], whereas Laguna criticizes it as a term without any actual meaning[343], and Harris infers that the OECD does not define it and if it exists the OECD expresses it indirectly[344]. To join the discussion, I think that it makes sense to analyze instances of hybrid mismatches and see what they have in common and if they include something that we could call hybrid element. As I show below, hybrid mismatches have three main sets of situations, *i.e.* hybrid entities, debt-equity hybrid financial instruments, and hybrid transfers.[345] Hybrid entities are an issue of different characterization of tax transparency or non-transparency. Debt-equity hybrid financial instruments are an issue of different characterization of a payment being an interest or a dividend. Hybrid transfers are an issue of different characterization of who is an owner (entitled to benefits) of a financial instrument. Therefore, hybrid element, if it exists, must be something that exists in all of these situations.

Hybrid entities appear due to the application of different characterization rules.[346] In my view, their hybridity can be either innate or external. Hybrid entities are fiscally non-transparent under tax law of one country while being tax transparent under tax law of another country. Hybrid entities are thus hybrid because hybrid entity is still one legal entity but two (or more) countries characterize it differently. However, this situation is generally not something which is innate to such legal entity but it is actually something that appears because of rules tax law uses to characterize particular taxpayers. Truth is that certain forms of legal entities, *e.g.* partnerships and trusts, attract hybrid handling in tax laws more than others.[347] To that extent, hybridity can be innate to these entities to some extent and some approaches toward foreign legal entities can recognize something like innate hybrid provision which would give rise to two or more countries categorizing such legal entity conversely. However, the hybridity of hybrid entities is still mainly external because external tax rules consider them differently.[348]

Regarding debt-equity hybrid financial instruments, I think the hybrid element can dwell in provisions of financial instrument (including statutory provisions which are automatically part of the

[341] OECD, ref. n. 20, p. 18, par. 13-14.
[342] PARADA, Leopoldo, ref. n. 8, p. 282-284.
[343] See MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 144-147.
[344] See HARRIS, Peter, ref. n. 324, p. 241, 245-246.
[345] For a different categorization see HARRIS, Peter, ref. n. 324, p. 303-309.
[346] See *e.g.* PARADA, Leopoldo, ref. n. 29, p. 974-975. ; THURONYI, Victor, ref. n. 4, p. 1054.
[347] See *e.g.* OECD. *The Application of the OECD Model Tax Convention to Partnerships*. Paris: OECD, 1999. Issues in International Taxation, 6. DOI: https://dx.doi.org/10.1787/9789264173316-en. ISBN 9789264173316.
[348] It is certainly outside of scope of the dissertation, but I wanted to express that hybrid element of hybrid entities could dwell in provisions of bylaws or private law dealing with these entities. Commonly, main issue is that these entities sometimes have and sometimes do not have legal personality. Or they have a legal personality but do not constitute

instrument).[349] Thus, the issue is that tax law rules can look closely to categorize a financial instrument, but some tax law rules may see debt financing whereas other rules may see equity financing. Moreover, debt-equity financial instruments can have a Schrödinger's cat form, *e.g.* convertible bonds, redeemable preference shares, profit participation loans, perpetual debts or contingent convertibles[350], because it is not obvious what kind of financing it is until the instrument expires or converts into equity. Hence it seems to me that if hybrid element exists, it is more innate to debt-equity hybrid financial instruments than hybrid entities. Also, debt-equity hybrid financial instruments certainly have the outward hybridity like hybrid entities because two or more rules can categorize them differently due to specific setting of these rules.

Hybrid transfers form a specific set of hybrid mismatches and their hybrid element, if it exists, is also an outward one, because their hybridity depends on applicable rules of countries involved.

All in all, the discussion vis-a-vis the definition of hybrid mismatches has been so far inconclusive of what constitutes hybrid element and if this element actually exists.

3.2.3 What is the Relationship of the Terms Hybrid Mismatches and Hybrid Mismatches Arrangements?

The term hybrid mismatch has at least two meanings.[351] In tax theory, the term *hybrid mismatch* descriptively denotes a tax phenomenon without any normative judgement. In the OECD tax policy, the term *hybrid mismatch* entails a specific subset of *hybrid mismatch arrangements* listed in the OECD BEPS Project Action 2 recommendations.[352] The OECD BEPS Project Action 2 uses the term *hybrid mismatch arrangement* to narrow[353] the tax theory term *hybrid mismatch* to deal only with hybrid mismatches that lead to non-taxation outcomes that the OECD considers unwanted and emphasizes that an arrangement takes place, the hybrid mismatch is a product of such arrangement, and such arrangement leads to non-taxation.[354]

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[349] The BEPS Action 2 certainly views hybrid element in this. See MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 145-146.

[350] See *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 16.

[351] As I showed above, some authors use the term hybrid mismatches interchangeably with the term hybrid arrangements.

[352] Recommendations 1.3, 3.3, 4.3, 6.3, 7.3. The definition itself is in recommendation 12 stating that "*a hybrid mismatch is defined in paragraph 3 in Recommendations 1, 3, 4, 6 and 7 for the purposes of those recommendations*". OECD, ref. n. 20, p. 166.

[353] The reason for it is that it is practically impossible to deal with all instances of hybrid mismatches. For the literature summary of the topic see COOPER, Graeme S. Some Thought on The OECD's Recommendations on Hybrid Mismatches. *Bulletin for International Taxation*. 2015, 69(6/7), p. 334-336.

[354] See COOPER, Graeme S., ref. n. 353, p. 335-343.

3.2.4 Definition of Hybrid Mismatches in EU Tax Law

EU tax law deals currently with hybrid mismatches in two directives, *i.e.* the PSD and the ATAD. The PSD does not use the term hybrid mismatch but deals with outcomes of debt-equity hybrid financial instrument situations under which the PSD applies only the regular linking rule.[355] The ATAD uses the legal term *hybrid mismatch* to define what situations EU law considers as leading to DD or D/NI outcome when the ATAD's linking rules apply.[356] The ATAD defines the term hybrid mismatch using a list of seven situations involving a taxpayer or an entity who fiscally transparent.[357] These situations encompass are (i) D/NI outcome situations, *i.e.* a debt-equity hybrid financial instrument situation[358], disregarded payment to hybrid entity[359], a payment allocation mismatch between the head office and permanent establishment or permanent establishments[360], a payment to a disregarded permanent establishment[361], disregarded payment made by hybrid entity to its owner[362], a disregarded deemed payment between head office and permanent establishment or between permanent establishments by the payee jurisdiction[363], and (ii) generally any situation when DD outcome arises.[364] The ATAD however narrows the scope of linking rules situations between tightly connected legal entities in similar manner as the OECD does.[365]

3.3. Hybrid Entities and Reverse Hybrid Entities

3.3.1 Tax Theory Definition of Hybrid Entities

As I have mentioned in Chapter 2, the legislator must decide who a taxpayer under income tax law is, *i.e.* whose income is subject to income taxation. Taxpayers are individuals and legal entities. Nonetheless, jurisdictions sometimes divide in decision which legal entities are taxpayers. For instance, trusts, collective investment schemes, and partnerships may be taxpayers in some countries (*fiscally non-transparent*) but disregarded for tax purposes in other countries (*fiscally transparent*). Thus, one country can view partnerships as taxpayers whereas another country can disregard them.

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355 See explicitly Article 4(1)(a) of the PSD. Kahlenberg and Kopec argue that also Article 4(1)(b) of the PSD deals with the indirect credit method in similar scenarios. See KAHLENBERG, Christian and Agnieszka KOPEC. Hybrid Mismatch Arrangements - A Myth or a Problem That Still Exists? *World Tax Journal*. IBFD, 2016, 8(1), p. 69-70. See *ibid*, p. 69-71, for the description of the regular linking rule in the PSD.

356 See Article 2(9) of the ATAD.

357 See Article 2(9) of the ATAD and Article 9(3) of the ATAD.

358 See Article 2(9)(a) of the ATAD.

359 See Article 2(9)(b) of the ATAD.

360 See Article 2(9)(c) of the ATAD.

361 See Article 2(9)(d) of the ATAD.

362 See Article 2(9)(e) of the ATAD.

363 See Article 2(9)(f) of the ATAD.

364 See Article 2(9)(g) of the ATAD. See also FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS. Hybrid Mismatches Under the ATAD I and II. *EC Tax Review*. 2017, 26(3), p. 158.

365 See Article 2(10) and (11) of the ATAD.

The academic literature is largely settled on the definition of hybrid entities.[366] However, some authors suggest different definitions on the grounds of what they perceive as the underlying issue of hybrid entities.[367] The IBFD Tax Glossary defines hybrid entities as "*(…) an entity that is characterized as transparent for tax purposes (e.g. as a partnership) in one jurisdiction and non-transparent (e.g. as a corporation) in another jurisdiction. An entity that is treated, from the point of view of a particular jurisdiction, as transparent in that jurisdiction and as non-transparent in the other jurisdiction is sometimes referred to as "regular hybrid". In contrast, an entity is a reverse hybrid when it is treated from the point of view of a particular jurisdiction as non-transparent and as transparent in the other. A hybrid entity is, therefore, also always a reverse hybrid, the difference depending on whether the classification is being made from the point of view of the jurisdiction treating the entity as transparent (hybrid) or non-transparent (reverse hybrid).*" Hybrid entity is thus an entity which the country, where the entity is a tax resident, recognizes as a taxpayer, but the country, where, for example, its shareholders (investors) are tax residents, does not recognize the legal entity as the taxpayer. Similarly, "a *reverse hybrid entity is one which is NOT recognized as a taxpayer in the country where it is set up, but IS recognized as a taxpayer in the country where its investors are tax resident*."[368] Hence an answer to a question whether some entity is hybrid or reverse hybrid, depends on the perspective of which jurisdiction is posing the question. To simplify the discussion a little bit, I use for the purpose of this dissertation the definition promoted by Kahlenber and others, *i.e.* the hybrid entity "*is classified as opaque in its state of domicile and – in deviation – as fiscally transparent in the source state*" and the reverse hybrid entity "*is classified as fiscally transparent in its state of domicile and – in deviation – as opaque in the source state*".[369]

For the purposes of illustrating examples of hybrid mismatches in following figures, I use the common notation of hybrid entities, reverse hybrid entities, and branches (see Figure 3).

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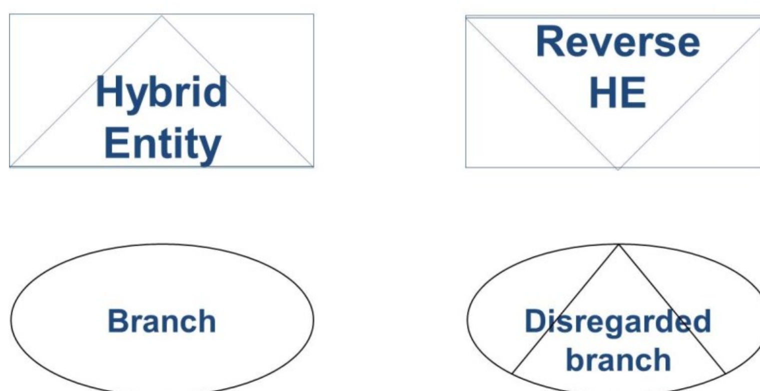
[366] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 358. ; HOFSTÄTTER, Matthias and Daniela HOHENWARTER-MAYR, Chapter 6 – The Merger Directive. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 188. ; GOVIND, Sriram and Stephanie ZOLLES, Chapter 8 – The Anti-Tax Avoidance Directive. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 188. ; OECD. Glossary of Tax Terms. OECD [online]. Paris: Organisation for Economic Co-operation and Development, 2020 [cit. 2020-07-29]. Available at: https://www.oecd.org/ctp/glossaryoftaxterms.htm#H. ; KRAHMA, Andriy. INTERNATIONAL HYBRID INSTRUMENTS: JURISDICTION DEPENDENT CHARACTERIZATION. *Houston Business And Tax Law Journal*. 2005, 2005(V), p. 100. ; PARADA, Leopoldo, ref. n. 29, p. 974.

[367] See KAHLENBERG, Christian, ref. n. 169, p. 148.

[368] See OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 368.

[369] KAHLENBERG, Christian, ref. n. 169, p. 148.

Figure 3 *Notation Used in Examples*

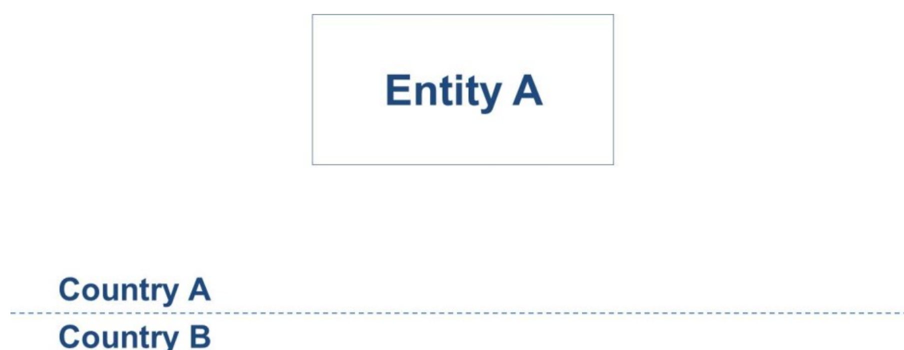


3.3.2 Model Examples and Possible Outcomes of Hybrid Entities and Reverse Hybrids

Let us suppose a situation with entities A and B.[370, 371] Entity A is a taxpayer (fiscally non-transparent) and tax resident in Country A. Entity B is formed under Country B law and is a taxpayer (fiscally non-transparent) and a tax resident there. Country A does not consider Entity B as a taxpayer, *i.e.* Entity B is fiscally transparent for Country A's tax purposes and Country A considers this entity as merely Entity A's branch. Entity A is a majority partner of Entity B. Entity A lends money to Entity B at a predetermined interest rate. Consequently, Entity B pays interest to Entity A and claims a deduction from taxable income achieved in Country B. Entity A does not recognize any income because from its perspective Entity B is part of Entity A, not a separate taxpayer. See Figure 4 for the Country A's perspective,

Figure 5 for the Country B's perspective, and Figure 6 for the merged perspective of both countries.

Figure 4 *D/NI Hybrid Entity Model Example: Country A Perspective*



[370] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 365-366.

[371] For other examples of hybrid entities see *e.g.* LÜDICKE, Jürgen. "Tax Arbitrage" with Hybrid Entities: Challenges and Responses. *Bulletin for International Taxation*. 2014, 68(6/7), p. 1-14. ; PARADA, Leopoldo, ref. n. 29, p. 978-979. For historical examples of hybrid entities see *e.g.* BOIDMAN, Nathan and Michael KANDEV. BEPS on Hybrids: A Canadian Perspective. *Tax Notes International*. 2014, 2014(June 30, 2014), p. 1233-1234.

Figure 5 *D/NI Hybrid Entity Model Example: Country B perspective*

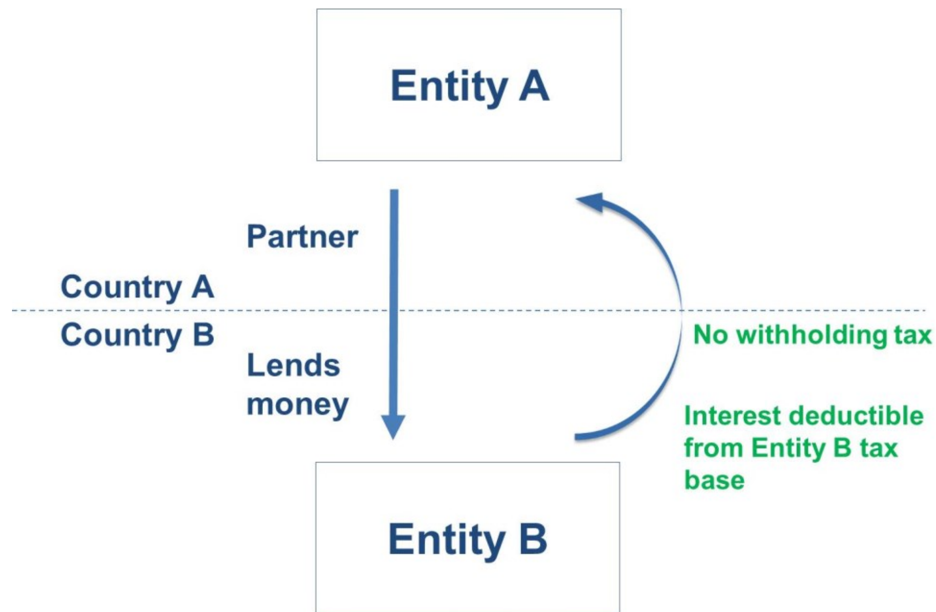
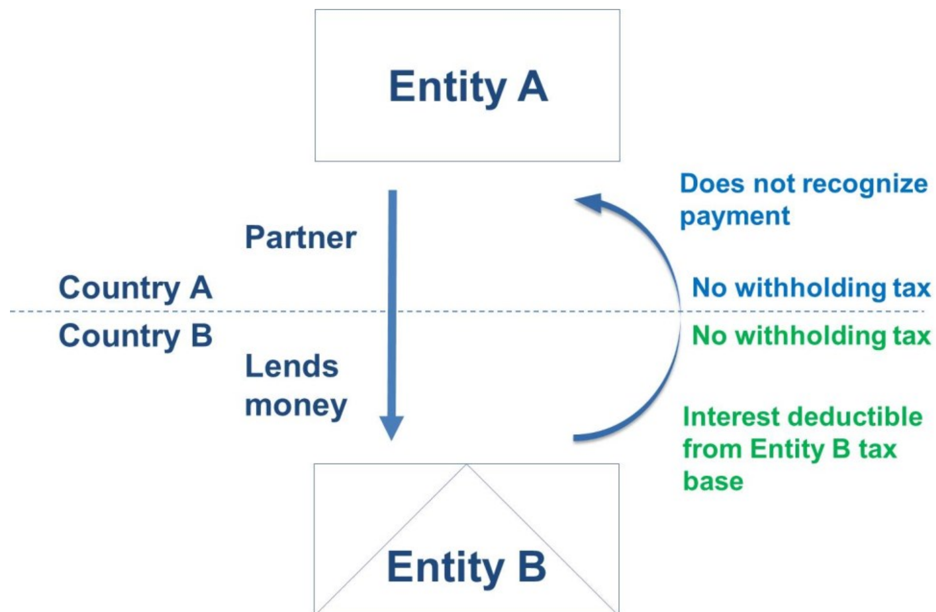


Figure 6 *D/NI Hybrid Entity Model Example: Country A and B perspective*

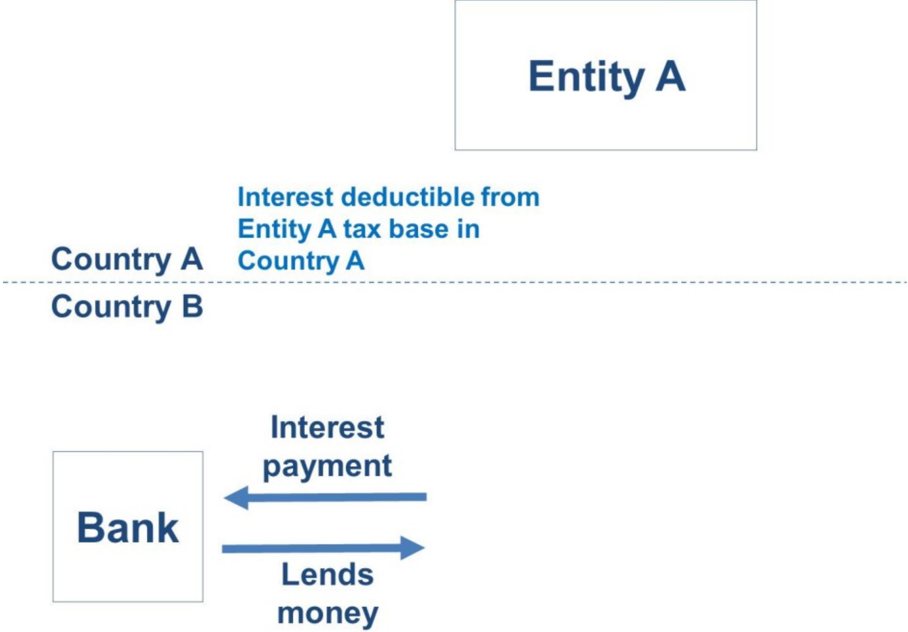


Hence this example leads to a deduction of an expense without an inclusion of a corresponding income, *i.e.* D/NI outcome. It means that a payment lowers tax base in one jurisdiction, *i.e.* that jurisdiction does not tax income at the Entity B and does not tax the payment of the interest to Entity A because Country B expects Country A to tax it according to their double tax treaty which assigns the right to interest taxation to the residence country of the creditor, *i.e.*

Country A. However, Country A does not recognize income because intra-taxpayer payments do not constitute income under Country A tax law.[372]

Let us suppose another situation with Entities A and B having the same characteristics as in the previous example, *i.e.* Entity B is a hybrid entity from the Country A perspective and a reverse hybrid entity from the Country B perspective.[373] Entity B takes a loan from a local financial institution, *e.g.* bank, and has to pay an interest. Entity B then claims a deduction for interest payment in Country B and Entity A claims a deduction for interest payment in Country A.

Figure 7 *Double Deduction Hybrid Entity Model Example: Country A Perspective*



[372] For example because Country A's income tax law rests on SHS definition of income and sending money from one bank account to another of the same taxpayer does not lead to income creation, *i.e.* does not increase taxpayer's net wealth.

[373] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 366.

Figure 8 *Double Deduction Hybrid Entity Model Example: Country B Perspective*

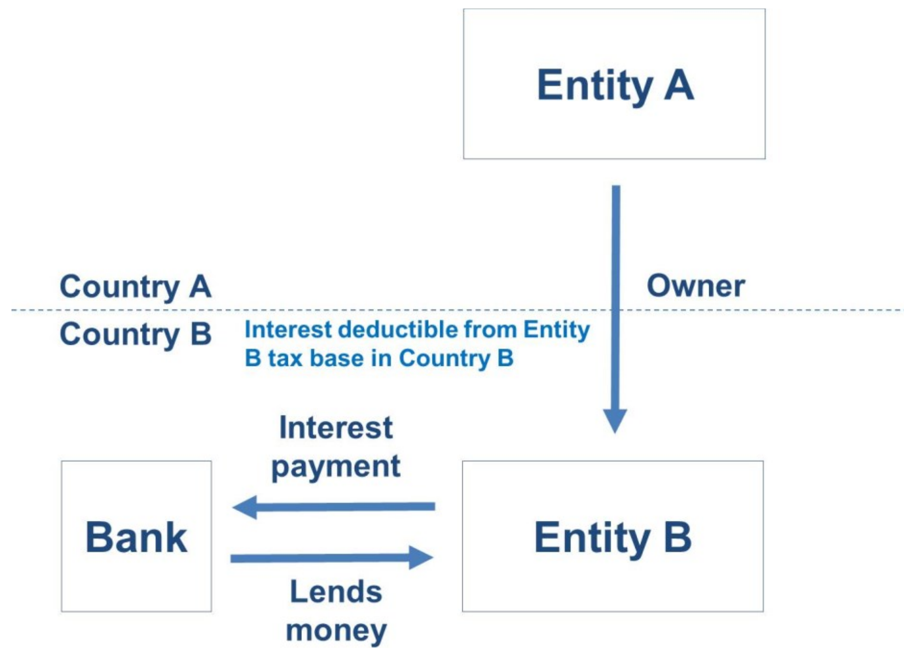
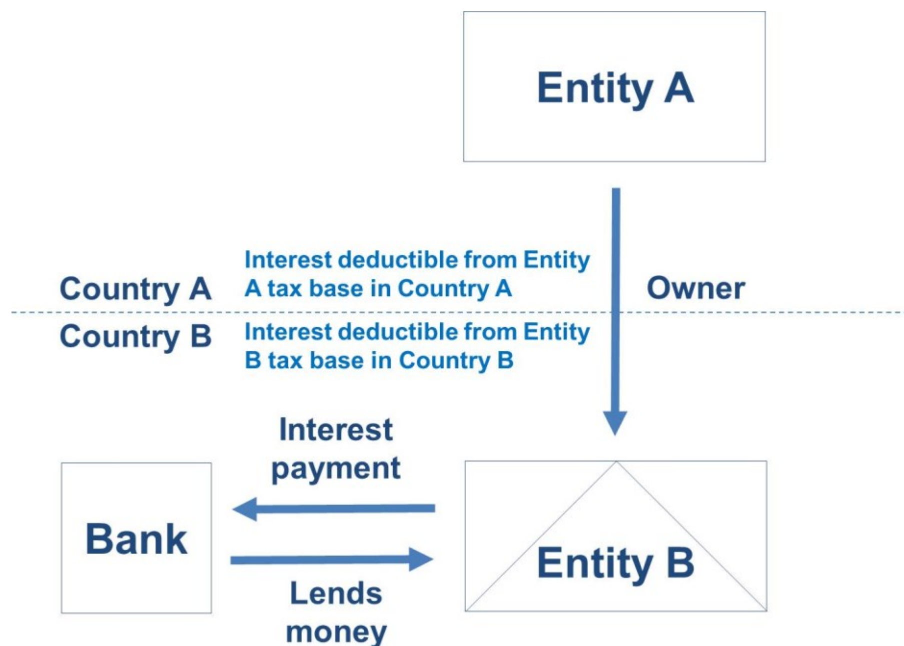


Figure 9 *Double Deduction Hybrid Entity Model Example: Country A and B Perspective*



Hence this example leads to a double deduction of one interest expense, *i.e.* the double deduction outcome.

Let us suppose a new situation with Entities A, B, and C.[374] Entity A is a taxpayer and tax resident in Country A. Entity B is established under Country B law. Entity B is not a taxpayer under Country B tax law but Country A considers Entity B as a taxpayer. Entity B is thus a reverse hybrid

[374] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 368.

from the perspective of Country A. Entity C is a taxpayer in Country C and recognized as a taxpayer in Country A and B. Entity B gives a loan to Entity C. Entity C pays interest to Entity B and claims a deduction in Country C. Country B does not recognize a taxable income because Country B does not perceive Entity B as a taxpayer. Country B therefore treats Entity B as fiscally transparent and assumes that Country A has a right to tax interest income. Meanwhile, Country A treats Entity B as fiscally non-transparent and presumes that Country B has a right to tax interest income.

Figure 10 *D/NI Reverse Hybrid Entity Model Example: Country A Perspective*

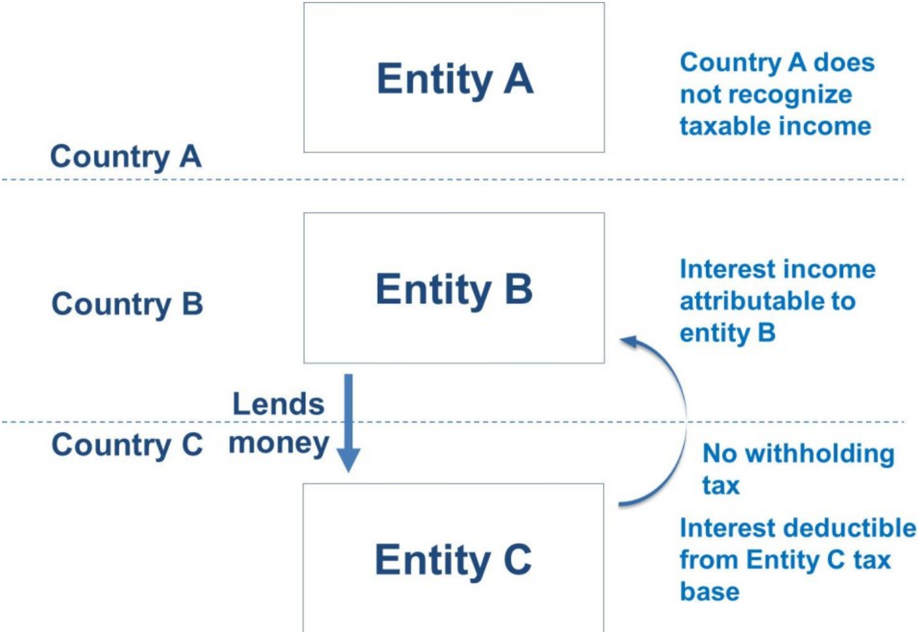


Figure 11 *D/NI Reverse Hybrid Entity Model Example: Country B Perspective*

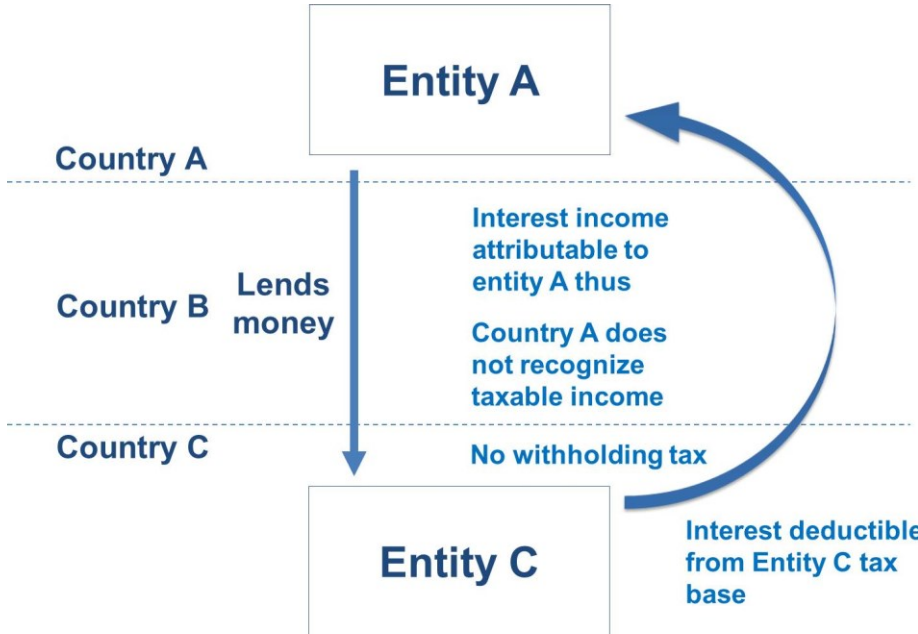
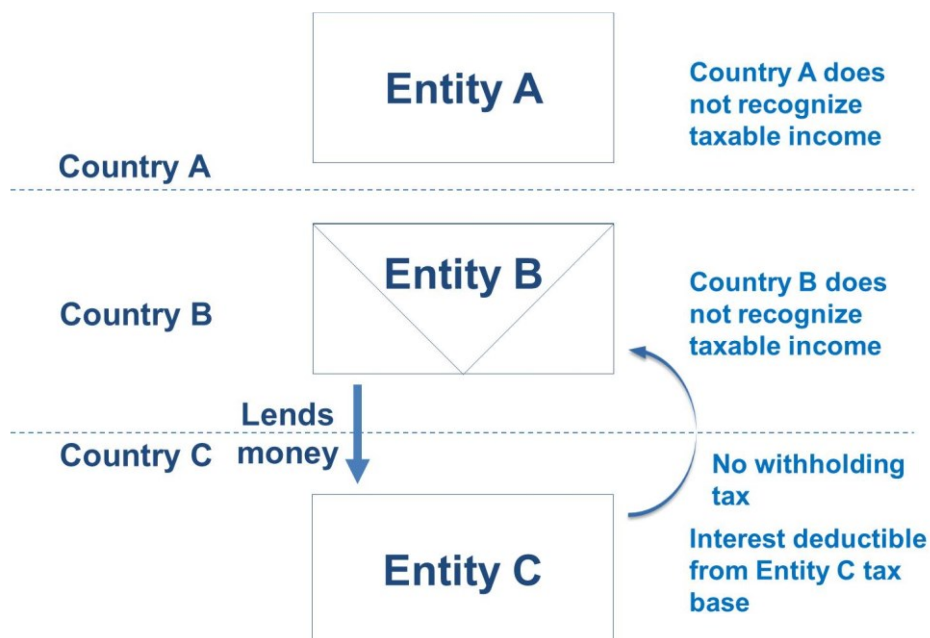


Figure 12 *D/NI Reverse Hybrid Entity Model Example: Country A and B Perspective*



Hence this example leads to the deduction without an inclusion of income outcome.

These model examples show that hybrid entities and reverse hybrid entities can create deduction/no inclusion and double deduction outcomes which are beneficial for taxpayers because they lower their overall tax duty. However, it is important to emphasize that different classification of hybrid entities, reverse hybrid entities, and their payments can also have detrimental outcomes for taxpayers.[375]

3.3.3 Tax Policy Definition of Hybrid Entities

The OECD BEPS Project Action 2 defines hybrid entities as hybrid payers and reverse hybrids. A person (legal entity) is a hybrid payer where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be a disregarded payment.[376] A reverse hybrid is any person that is treated as a separate entity by the investor's jurisdiction and as fiscally transparent under the laws of the establishment jurisdiction.[377]

3.3.4 EU Law Definition of Hybrid Entities

EU Law defines hybrid entities in the ATAD[378] as "*any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure*

[375] See *e.g.* Van Raad writing in the general report that "*double taxation frequently remains unrelieved. This occurs if a residence State includes the S-income in the taxable income of its resident entrepreneur but refuses, usually for reasons of subject-nonidentity, to apply regular double taxation relief*". VAN RAAD, Kees. Recognition of foreign enterprises as taxable entities - General Report. IFA Cahiers. 1988, 73(a), p. 57. For a thorough discussion of these situations see *ibid*, p. 30-57.

[376] The Recommendation 3.2(b) of BEPS Action 2 Report.

[377] The Recommendation 4.2 of BEPS Action 2 Report.

[378] Article 2(9)(i) of the ATAD.

of one or more other persons under the laws of another jurisdiction". The definition applies only for the ATAD's purposes.[379]

3.4. Hybrid Financial Instruments

3.4.1 Tax Theory Definition of Hybrid Financial Instruments

Hybrid financial instruments are a subset of financial instruments.[380] This subset encompasses financial instruments giving rise to legal mismatches due to their complicated legal characterization by two or more countries (jurisdictions).[381] Their characterization is complicated because hybrid financial instruments contain provisions (terms)[382] that tax laws can attribute to various types of agreements, securities or financing forms.[383] This ambivalence creates issues in tax law design which uses legal norms constituting binary characterization of cash-flow for income tax purposes.[384] These legal norms are not well-adjusted[385] to deal with the fact that hybrid financial instruments contain provisions attributable to debt financing as well as equity financing. This can lead to mismatches in categorization of remuneration arising out of these financial instruments that

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[379] For a brief discussion about hybrid entities under the ATAD see *e.g.* FIBBE, Gijs. Chapter 18 - Hybrid Mismatch Rules under ATAD I & II. PISTONE, Pasquale and Dennis WEBER, ed. *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study*. Amsterdam: IBFD, 2018, p. 410-415. ISBN 978-90-8722-446-2.

[380] For a very brief introduction to financial instruments in income taxation, see *e.g.* BANKMAN, Joseph, Daniel N. SHAVIRO, Kirk J. STARK and Edward D. KLEINBARD, ref. n. 131, p. 315-316.

[381] For the thorough discussion of hybrid financial instruments see *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 9-70. See also *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 377-378. As I have stated in introduction, my ambition is not to deal with hybrid financial instruments in too much detail because exhaustive and detailed works have been already published on hybrid financial instruments. See *e.g.* BÄRSCH, Sven-Eric, ref. n. 42. ; BUNDGAARD, Jakob, ref. n. 43. ; MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44.

[382] In regard to the OECD BEPS Action 2 see *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 26-28.

[383] See *e.g.* BLESSING, Peter H., ref. n. 154, p. 202-204. ; PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 16. ; PARADA, Leopoldo. Is It Debt or Is It Equity? The Problem With Using Hybrid Financial Instruments. *Tax Notes International*. 2014, 2014(April 28, 2014), p. 347-348. ; CLOR-PROELL, Shana, Lisa KOONCE and Brian WHITE. How Do Experienced Users Evaluate Hybrid Financial Instruments? *Journal of Accounting Research*. 2016, 54(5), p. 1267-1269. DOI: 10.1111/1475-679X.12129. ISSN 00218456. Available at: http://doi.wiley.com/10.1111/1475-679X.12129.

[384] Blessing states it as a bimodal debt-equity framework and writes that an "*issue is whether an instrument may be bifurcated into multiple instruments* (...) *or whether characterization is done as a whole (the unitary approach). Most countries, including the United States, follow the unitary approach*" [footnote omitted]. BLESSING, Peter H., ref. n. 383, p. 202.

[385] Since binary tax rules create this issue, some scholars suggest using more continuous solution instead of binary or discrete solution in general. For an empirical analysis see FOX, Edward G. and Jacob GOLDIN. Sharp Lines and Sliding Scales in Tax Law. *Stanford Law and Economics Olin Working Papers Series*. 2019, 2019(534), p. 1-66. DOI: http://dx.doi.org/10.2139/ssrn.3339656. See in particular *ibid*, p. 59-63, for a discussion on debt-equity strict rules versus sliding scale. The debt-equity issue is common to many income tax systems and does not help with other forms of hybrid mismatches. See *e.g.* Schön stating that "*It seems to be a truth, universally acknowledge in the tax world, that the distinction between debt and equity, which plays a significant role in the current design of the individual and corporate income tax base, ought to be abolished in the short or medium-term future*". SCHÖN, Wolfgang, ref. n. 149, p. 490. For reasons why this distinction is pervasive see *ibid*, p. 490-502. Also the answer to question of using binary or non-binary rules depends on the distribution of the underlying set of cases. See *e.g.* FOX, Edward G. and Jacob GOLDIN, ref. n. 385, p. 25. For the discussion about possible solutions to debt-equity issue see *e.g.* BLESSING, Peter H., ref. n. 383, p. 208-212.

may have favorable, *e.g.* D/NI outcome, as well as adverse outcomes, *e.g.* double taxation[386], for parties to hybrid financial instruments.[387]

The hybrid financial instruments do not have any common generally accepted definition.[388] This leads to a difficulty because every author dealing with hybrid financial instruments has to use some form of a working definition of hybrid financial instruments.[389] Hybrid financial instruments are therefore defined in literature and law merely for particular purposes and the definitions vary depending on characteristics that an author of a specific definition wants to emphasize and what goal her work has. Thus, the definitions are usually economic, legal and/or a combination of both.[390] From reading the academic literature on hybrid financial instruments, I have distinguished three sets of definitions of hybrid financial instruments, *i.e.* the narrow definition, middle definition, and broad definition.

For example, Bärsch[391], Bundgaard[392] and other authors[393] define hybrid financial instruments as "*financial instruments that combine features found in equity as well as debt*". This definition stresses the fact that hybrid financial instruments are financial instruments[394] that lie on the debt-equity continuum but are neither pure debt nor pure equity.[395] In economic terms it means that hybrid financial instruments are a mixture of debt and equity financing.[396] In legal terms it means that hybrid financial instruments contain provisions giving rise to rights (corresponding obligations) that are

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386 PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 17.

387 ARNOLD, Brian J., ref. n. 315, p. 205.

388 See *e.g.* BÄRSCH, Sven-Eric. *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform*. Switzerland: Springer, 2012, p. 10. ISBN 978-3-642-32457-4. ; PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 16. ; KAHLENBERG, Christian and Agnieszka KOPEC, ref. n. 355, p. 42.

389 This can also lead to a certain confusion because hybrid financial instruments are hybrid from perspective of various disciplines, *e.g.* accounting, corporate financing, financial regulation, financial engineering, and tax law. Therefore, it is always crucial to know the context of the term hybrid financial instrument. For various perspectives on hybrid financial instruments see *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 9-70. The essential takeaway is that tax reasons are only one motive for using hybrid financial instruments in financing and tax law should deal with hybrid financial instruments accordingly.

390 This problem with finding the definition poses a hurdle in academic discussion as well as in tax policy discussion because authors do not use the term hybrid financial instruments only in tax law discussions but also when dealing with other fields, *e.g.* firm's financial management, accounting, securities regulation. Also, these definitions are intertwined because tax law can have its own explicit or implicit hybrid financial instrument definition or use other fields of law to define what is debt financing and what is equity financing, *e.g.* accounting definition, securities regulation. See *e.g.* LIBERADZKI, Marcin and Kamil LIBERADZKI. *Contingent Convertible Bonds, Corporate Hybrid Securities, and Preferred Shares: Instruments, Regulation, Management*. Netherlands: Palgrave MacMillan, 2019, p. 1-210. ISBN 978-3-319-92500-4. ; CLOR-PROELL, Shana, Lisa KOONCE and Brian WHITE, ref. n. 383, p. 1267-1269.

391 BÄRSCH, Sven-Eric, ref. n. 42, p. 9-10.

392 BUNDGAARD, Jakob, ref. n. 43, p. 3.

393 See *e.g.* FERRAN, Eilís and Look Chan HO. *Principles of Corporate Finance Law*. Oxford: Oxford University Press, 2014, p. 50-51. ISBN 978-0-19-967135-9.

394 In fact agreements usually in a form of securities, such as preference shares, convertible bonds, contingent convertible bonds ("Co-Cos" bonds), profit participation loans, and other instruments. See *e.g.* BLESSING, Peter H., ref. n. 383, p. 202. ; BUNDGAARD, Jakob, ref. n. 43, p. 271-386.

395 BUNDGAARD, Jakob, ref. n. 43, p. 3.

396 BUNDGAARD, Jakob, ref. n. 43, p. 3, 22-25.

usually attributed to, for example, loan agreements as well as to agreements providing equity in exchange for a share in a corporation.[397] Therefore, I call them debt-equity hybrid financial instruments because they give rise to payment which one country considers as debt whilst another country perceives as equity financing for income tax purposes. This narrower definition[398] excludes hybrid financial instruments which hybridity can lead to timing mismatches[399], value payments mismatches[400] and/or ownership mismatches but not due to the fact that they are somewhere on the continuum between pure debt and pure equity.

The second approach, which Kahlenberg and Kopec call a broad definition, states that hybrid financial instruments are instruments which contain "*certain components of both debt and equity capital*".[401] Since I show that some other authors discuss also other forms of hybrid financial instruments leading to other forms of mismatches, I use a term *middle definition* instead.

Arnold provides a hybrid financial instruments definition specifically for tax purposes as "*a financial instrument that is characterized differently* [for tax purposes] *by two countries*".[402] Similar definition uses when defines hybrid financial instruments as "*instruments that two or more countries involved in the same transaction treat differently for tax purposes because of a conflict in the tax jurisdictions' characterizations of the instrument*".[403] Both of these definitions emphasize the possibility of different characterization but do not base the different treatment on the fact that the HFIs are neither debt nor equity, *i.e.* hybrid financial instruments in a narrow sense.

A combination of the previous definitions are Lessambo's definition and Connors and Woll's definitions. Lessambo defines hybrid financial instrument as "*a finance instrument which is considered debt in one country, where the payment on the instrument is tax deductible, while in another country, the same instrument is treated as equity and the proceeds often constitute a tax-exempt dividend*.[404] Connors and Woll define HFIs as "*financial instruments that have both debt and equity characteristics and could potentially be classified as equity by one jurisdiction and as debt by another*".[405] These definitions combine characteristics of a specific subset of hybrid financial instruments I mentioned above that are characterized differently

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397 BUNDGAARD, Jakob, ref. n. 43, p. 22-25.
398 KAHLENBERG, Christian and Agnieszka KOPEC, ref. n. 355, p. 42.
399 Even though these mismatches often stem from differences between accrual and cash method of determining when the income is part of a tax base.
400 These mismatches are generally excluded from anti-hybrid rules in the OECD BEPS Action 2. See e.g. OECD, ref. n. 20, p. 18.
401 KAHLENBERG, Christian and Agnieszka KOPEC, ref. n. 355, p. 42.
402 ARNOLD, Brian J., ref. n. 315, p. 209.
403 DOMINGO, Maria S. Hybrid Mismatch.com: Neutralizing the Tax Effects of Hybrid Mismatch Arrangements. *North East Journal of Legal Studies*. 2019, 38(1), p. 9. Available at: https://digitalcommons.fairfield.edu/nealsb/vol38/iss1/1.
404 LESSAMBO, Felix I. *International Aspects of the US Taxation System.* New York: Palgrave Macmillan, 2016, p. 323. ISBN 978-1-349-94934-2.
405 As cited in KRAHMA, Andriy, ref. n. 366, p. 101.

in cross-border transactions due to their hybrid element that can be characterized as a debt by one jurisdiction and as equity by another jurisdiction. And countries can thus consider payments arising out of these hybrid financial instruments as, on the one hand, deductible interest, but, on the other hand, as a dividend exempted from tax base for income tax purposes leading consequently to a D/NI outcome.

Peeters and Vanneste use for the purpose of their article analyzing the BEPS Action 2 in relation to hybrid financial instruments this definition: "*an instrument that has (economic) characteristic that are inconsistent, in whole or in part, with the legal (more specific: tax) qualification of the instrument and hence the tax treatment of the payments under it* [footnote omitted] *that may lead to double non-taxation or double taxation*".[406] The definition emphasizes the difference between legal and economic behavior of the hybrid financial instrument. The definition is interesting move blending more the economic and legal characteristics of these instruments. However, regarding cross-border transactions, the issue stems from dividing legal characterization which does not have to be based on the difference between economic and legal qualification but only on the legal qualification which is rendered difficult by the economic structure of the instrument.

To sum up, there is still no generally applicable definition of hybrid mismatch purposes and thus I am using the narrow debt-equity hybrid financial instrument for the purpose of this dissertation (hereinafter notated also as "*D/E HFI*").

3.4.2 Model Examples and Possible Outcomes of Hybrid Financial Instruments

A common example of using hybrid financial instruments for tax planning is to create D/NI outcome using specific mismatches in tax law classification of the remuneration arising out of these financial instruments.[407]

Let us suppose the ACo is resident of Country A and is a full owner of a subsidiary BSub that is a taxpayer and a tax resident of Country B.[408] The ACo and the BSub want to lower their overall tax burden as a group because it is a cost lowering overall profit of the group. The ACo and BSub therefore enter into an agreement that is a hybrid financial instrument which Country B considers as debt financing for its tax purposes but Country A considers as equity financing for its tax purposes. Therefore, Country B considers payments arising out of this hybrid financial instrument as tax deductible interest and Country A considers these payments as tax-exempt dividend because of the participation exemption. The payment thus lowers tax base of BSub in Country B because it is a tax deduction but does not influence tax base of ACo in Country A.

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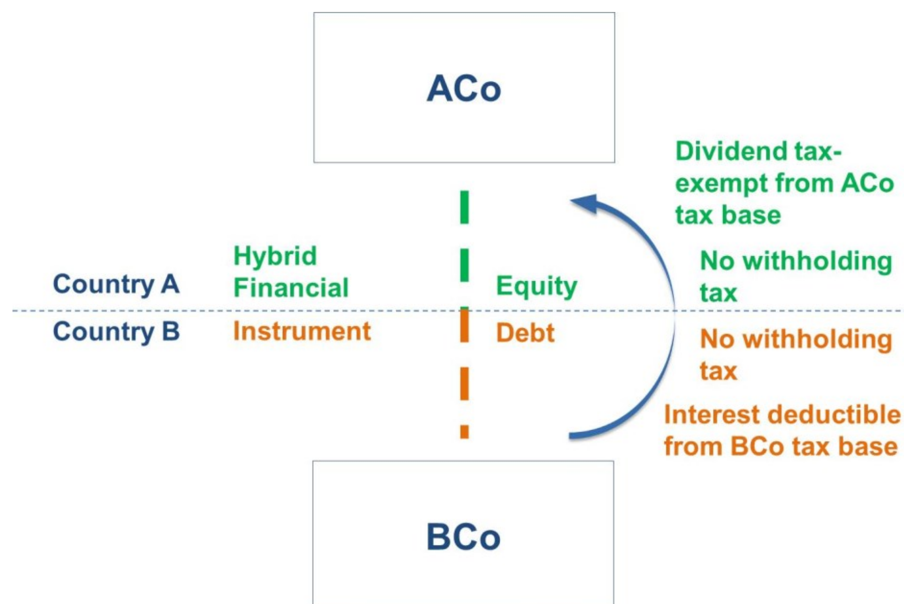
[406] PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 16.
[407] For more examples see *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 31 and following, 64-70.
[408] See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 360-363.

Figure 13 *Deduction / non-inclusion Hybrid Financial Instruments Model Example*



This leads to a D/NI outcome because neither Country A nor Country B tax income corresponding to the payment.

However, in the case relevant countries qualify payment stemming from the instrument *vice versa*, then the payment is subject to double taxation firstly as non-deductible dividend and then as an equity payment.

3.4.3 Tax Policy Definition of Hybrid Financial Instruments

The OECD BEPS Action 2 defines D/E HFI in general terms[409] as "*any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions and includes a hybrid transfer*".[410] This definition does not state what makes particular financial instrument a hybrid financial instrument.[411] The definition includes hybrid transfers under the term hybrid financial instrument.[412] Although the definition includes tax hybrid transfers among hybrid financial instruments, this inclusion makes sense mostly only for widening the linking rules dealing with D/NI outcome to include D/NI outcomes of hybrid transfers.[413] Otherwise, tax hybrid transfers are a specific subset of hybrid mismatches and I think it makes sense to deal with them on their own.

409 For the same assessment see *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 16.

410 OECD, ref. n. 20, p. 23. Recommendation 1.2(a) BEPS Action 2. Laguna is highly critical of the definition stating that the concept is murky and complex because it considers both debt, equity, and derivative arrangements and any other arrangement as long as tax law taxes them as debt, equity or derivative. According to Laguna, this can lead more complexity in implementation because tax law can use various definitions using either the *independent approach*, *i.e.* a special definition for tax law purposes, or the *dependency approach*, *i.e.* a tax law definition is dependent on a definition for other purposes such as accounting law or standards, financial regulation law, commercial law and others. LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 158-162.

411 OECD, ref. n. 20, p. 25, par. 20.

412 OECD, ref. n. 20, p. 26, par. 23-24.

413 For a discussion of such outcome, see *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 162-164.

3.4.4 EU Law Definition of Hybrid Financial Instruments

EU tax law implements[414] the OECD BEPS Action 2 D/E HFI definition by defining a term financial instrument in the ATAD as "*any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer*".[415] This definition also considers hybrid transfers as part of the hybrid financial instruments set which seems to me dubious for the same reason I have mentioned above. EU tax law contains another provision dealing with D/E HFIs in the PSD which contains a rule that is similar to the BEPS Action 2.[416]

3.5. Tax Hybrid Transfers

3.5.1 Tax Theory Definition of Tax Hybrid Transfers

Tax hybrid transfers are one of the subsets of hybrid financial instruments in the broad sense. Hybrid transfers differ from D/E HFIs because their main characteristic is that hybrid transfers give rise to a mismatch in how jurisdictions characterize ownership for income tax law purposes which can lead to a deduction/non-inclusion outcome (*foreign tax credit generator*) or double deduction outcome (*double-dipping*) using interest deduction or lease payments to get tax depreciation allowances.[417]

Several authors have discussed hybrid transfers in academic literature.[418] Lessambo defines hybrid transfers as "*arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralized loan*."[419] Arnold mentions hybrid financial instruments as stated above and uses as the example hybrid transfer instead of D/E HFI.[420] In general, Arnold's definition applies to hybrid financial instruments in the broad sense and therefore includes hybrid transfers. Cooper, in connection to the OECD BEPS Project Action 2 2014 Report, defines hybrid transfers as "*a disagreement regarding the nature of a transaction, i.e. the state where the recipient financier resides treats a "stock lending" or REPO arrangement as the purchase agreement of the underlying stock with the dividends received on the stock as tax exempt and the state where the payer borrower resides sees the transaction as a borrowing secured by the stock with the dividend payments equated*

[414] In same manner see *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 16.
[415] PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 15.
[416] See Recommendation 2.1 and Article 4(1)(a) of the PSD.
[417] OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 363-365. ; LESSAMBO, Felix I., ref. n. 404, p. 330-331.
[418] See *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 25-27. ; LESSAMBO, Felix I., ref. n. 404, p. 322. ; OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 363-365. ; ARNOLD, Brian J., ref. n. 299, p. 194-195. ; MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 162-164, 249-250. ; LANG, Michael, Erik PINETZ and Erich SCHAFFER, ref. n. 325, p. 10, 38-39.
[419] LESSAMBO, Felix I., ref. n. 404, p. 322.
[420] ARNOLD, Brian J., ref. n. 315, p. 209.

to deductible interest.[421] Peeters and Vanneste use a definition of hybrid transfers stating that "*a hybrid transfer is an arrangement or transaction with a financial instrument. As a consequence of the economics of the transaction and the way it is structured, the laws of different jurisdictions take opposing vies (from a tax perspective) as to whether the transferor or the transferee has the ownership of the underlying asset or whether an additional deductible payment should be organized. A hybrid transfer may also exploit differences between jurisdictions in attributing income from a financial asset with the effect that the same payment is treated as simultaneously received by different taxpayers who are resident in different jurisdictions*".[422]

To sum up, authors in general agree on the main elements of the definition of tax hybrid transfers, *i.e.* tax hybrid transfers are the transactions including transfers of financial instruments that countries categorize differently.

As I have discussed above, the theoretical question is whether hybrid transfers are actually *hybrid* because the mismatches they produce are results of mismatches of tax rules, *e.g.* rules giving tax credit for withholding tax. The underlying reason for these mismatches is that countries differ in what constitutes securities ownership for giving tax credit. Thus, the question is who a taxpayer entitled to tax credit benefits is. Is it a taxpayer who has legal ownership of securities, or is it a taxpayer who has economic ownership of these securities but temporarily lacks the legal title to these securities? Therefore, the hybrid element exists only because of the applicable rules but would not exist without them. So I infer that if tax hybrid transfers include a hybrid element, it is an external one. I also prefer the term tax hybrid transfers over just hybrid transfers to differentiate these transfers from hybrid transfers in other fields of law because the hybrid aspect of the transfers considered as hybrid transfers is specific for tax law because it leads to tax specific issues.[423]

3.5.2 Model Examples and Possible Outcomes of Hybrid Transfers

Two model examples of hybrid transfers are (i) share sale and repurchase agreement and (ii) share lending arrangement.[424]

3.5.2.1 Loan Structured as a Share Sale and Repurchase Agreement

The common example of hybrid transfer is a sale and repurchase agreement (*repo*).[425] A repurchase agreement (or reverse repurchase agreement) is an agreement involving the sale of

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[421] COOPER, Graeme S., ref. n. 353, p. 336.

[422] PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 25.

[423] Laguna says that the term tax hybrid transfers may "*relate to certain types of puttable instruments as considered from a financial accounting perspective*". However, since it is obvious that I use the term tax hybrid transfers in tax law and BEPS Action 2 context, I keep using the term tax hybrid transfers for reasons I have described above.

[424] For examples of hybrid transfer leading to D/NI outcome, see *e.g.* Examples 1.31 and 1.32 of the BEPS Project Action 2. OECD, ref. n. 20, p. 256-265.

securities by one party to another with a promise to repurchase the securities at a specified price and on a specified date in the future.[426] Repos in general serve as a way to get external financing and are common in banking industry and financial system in general.[427] Parties can structure the repos on national levels using third party securities (*e.g.* government securities). In that case, the repo agreement between a borrower (Company A) and a lender (Company B) contains provisions that state that the lender buys shares from the borrower for certain price and, after the term of the loan ends, sells it back for the previous price plus interest (equaling usually the higher price).

Lessambo describes a model example using an SPV,[428] but it is not necessary to use the SPV.[429] The borrower (Company A in Country A) seeks financing from the lender (Company B in Country B). The borrower establishes special purpose entity (ASub in Country C)[430], provides it with equity, and gets in exchange ordinary and preferred shares[431] of ASub (see Figure 14). The Company A then enters a repurchase agreement ("*a net paying repo*")[432] with the Company B.[433] Under the repo agreement provisions, the Company B obtains preferred shares of the ASub from the Company A for a set price (see Figure 15). After certain time, the Company B sells the preferred shares back to Company A and obtains money (see Figure 18). In the meantime, the ASub distributes dividend to holders of preferred shares and pays withholding tax in Country C (see Figure 16). Country B considers the repo agreement in a formal manner as "*a sale and repurchase of the SPV shares*"[434], assigns ownership of ASub shares to Company B, and allows Company B to apply foreign tax credit for withholding tax in Company C. Country A however considers the repo agreement in a material manner as "*a loan secured through the SPV shares*"[435] and understands that the whole transaction is only temporary and that long-term owner is still Company A. Country A therefore assigns the ownership of the dividend to the Company A (see Figure 17). Company A can thus use foreign tax credit for the withholding tax from Country C.

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425 See *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 363-365. ; LAW, Shee Boon and Marjolein KINDS. Hybrid Instruments in the Post-BEPS Era. COTRUT, Madalina. *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures.* Amsterdam: IBFD, 2015, p. 130-132. ISBN 978-90-8722-333-5.

426 LESSAMBO, Felix I., ref. n. 404, p. 325.

427 LESSAMBO, Felix I., ref. n. 404, p. 325.

428 LESSAMBO, Felix I., ref. n. 404, p. 325. See also OECD, ref. n. 329, p. 9-10.

429 See Example 1.31 in OECD, ref. n. 20, p. 256-260.

430 The borrower can establish SPV also in Country A. In such a situation the outcome is probably that Country B gives Company B (the lender) a foreign tax credit while Country A exempts dividends from Company A's tax base because of the participation exemption. OECD, ref. n. 329, p. 10.

431 Shares bearing generally only a right to receive a dividend.

432 On the difference between the repo and the net repo see *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 25-26.

433 A net paying repo means that "*the lender retains the dividend as part of the agreed returen on the loan*". OECD, ref. n. 20, p. 257.

434 OECD, ref. n. 329, p. 9.

435 OECD, ref. n. 329, p. 9.

Figure 14 *Company A Establishes ASub*

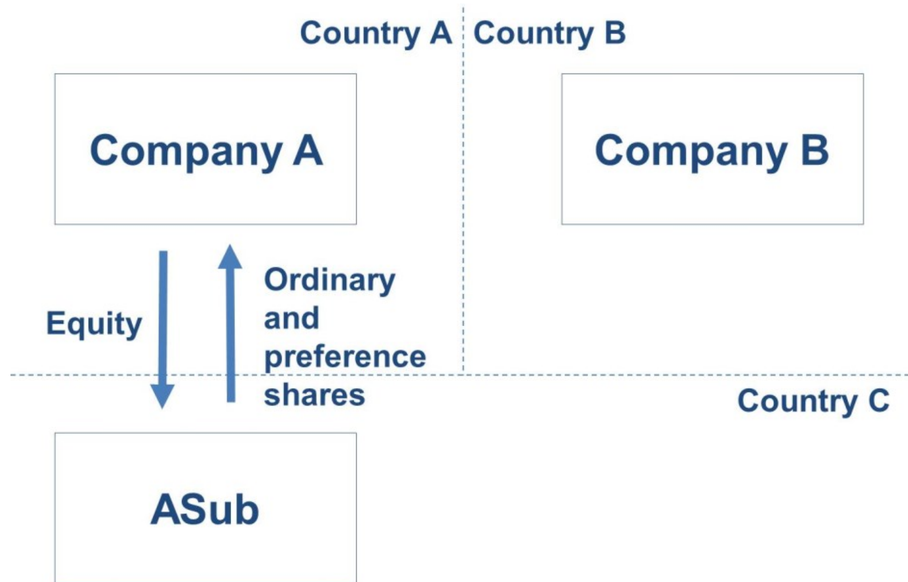


Figure 15 *Conclusion of the Repurchase Agreement between Company A and Company B*

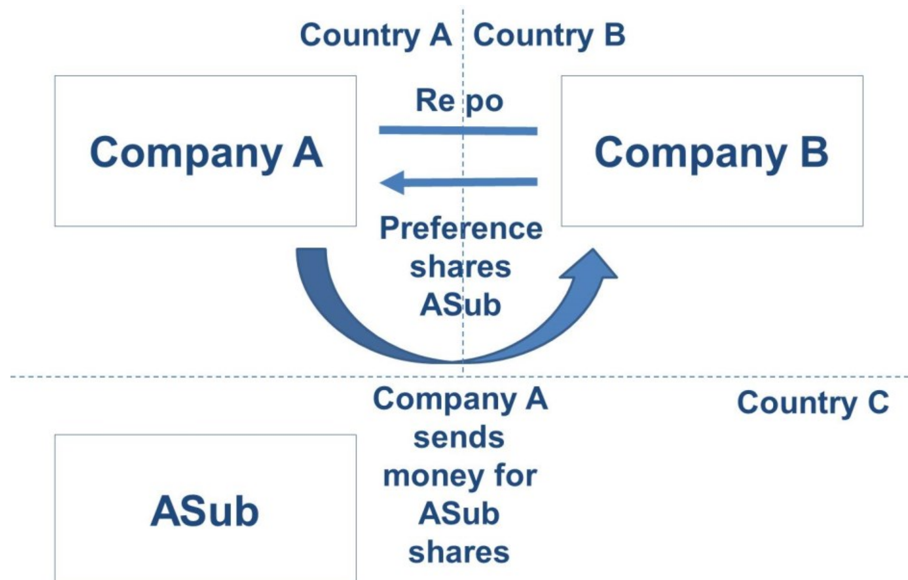


Figure 16 *ASub Pays Dividend Payment to Company B (Country B Perspective)*

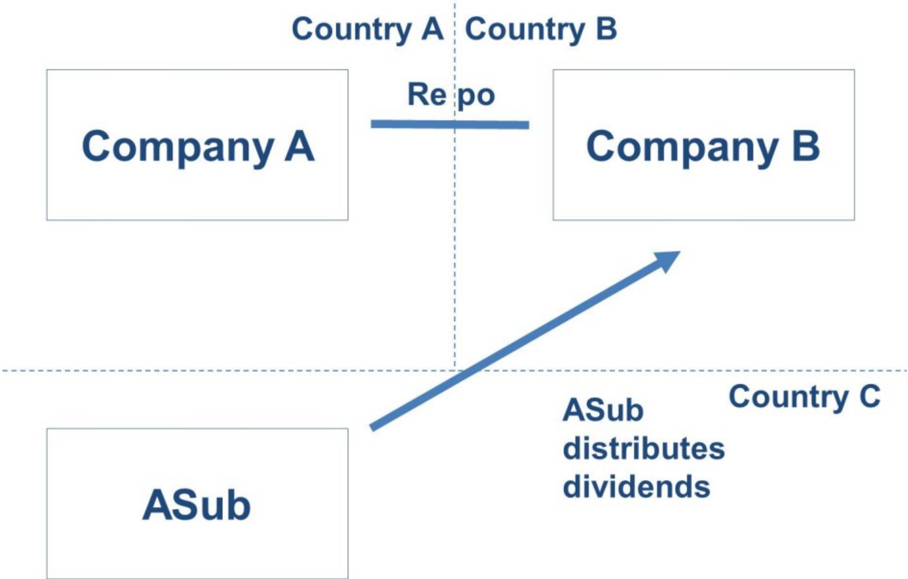


Figure 17 *ASub Pays Dividend Payment to Company B (Country A Perspective)*

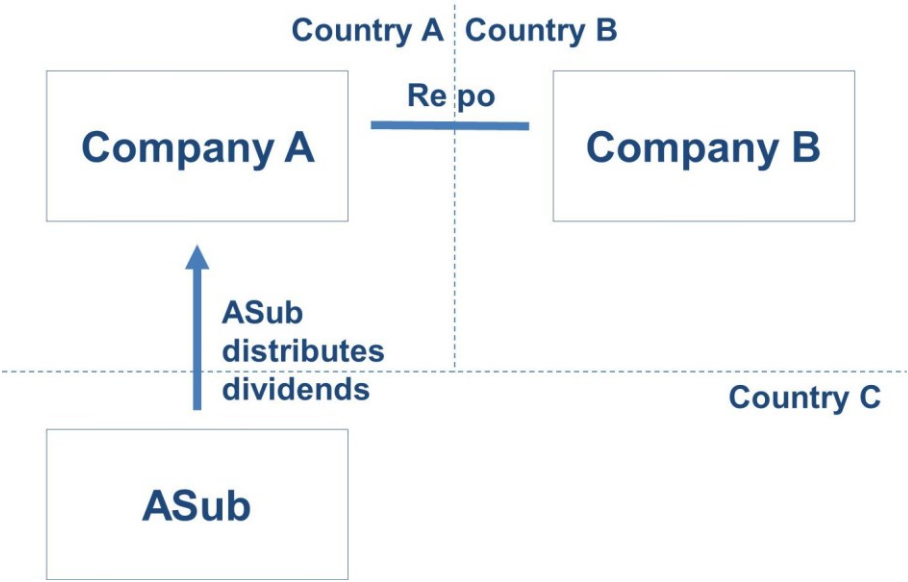
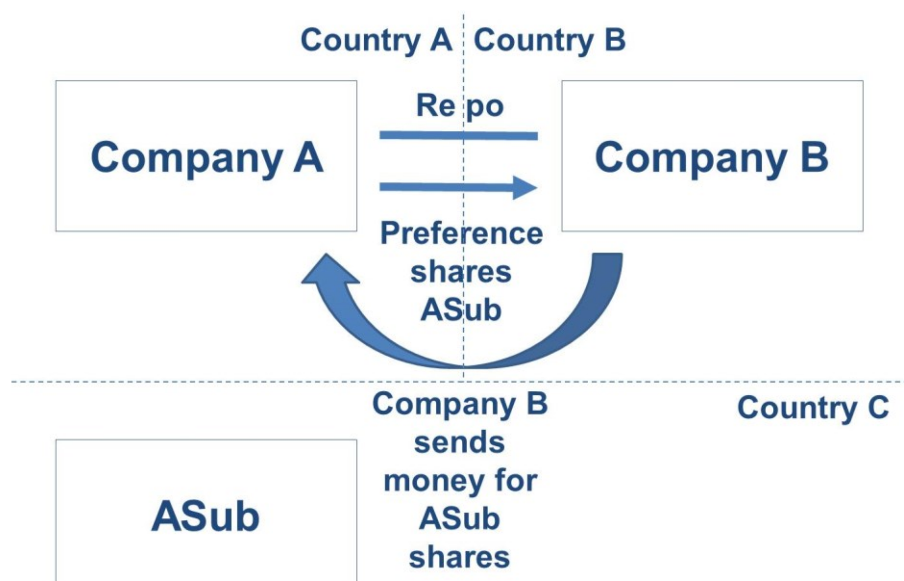


Figure 18 *Settlement of Repurchase Agreement*



Hence the outcome is that two taxpayers created a foreign tax credit in two countries but only for one payment.

3.5.2.2 Share Lending Arrangement

Share lending arrangement example includes Company A (tax resident in Country A), and Company B (tax resident in Country B).[436] Company A owns shares of a Company C situated in Country B. Company A (lender) lends these shares to Company B (borrower). The borrower has an obligation to return the same or identical shares to the lender in future, and the lender still bears an economic risk of holding shares. If the lender wants to protect itself against the borrower´s default, the lender can ask collateral (*e.g.* investment grade debt securities) of the same value as the borrowed shares.

The share lending arrangement differs from the repo in the detail that "*the original transfer is not for a defined amount of consideration*."[437] Also, the parties to the repo count the value of the dividend into the price of the repo whereas this is not the case in share lending arrangement where the borrower must make a manufactured dividend payment to Company A. The economic reason for share lending arrangement is usually a *short sale*.[438]

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[436] See *e.g.* Example 1.32 in OECD, ref. n. 20, p. 261-265.
[437] OECD, ref. n. 20, p. 261.
[438] HULL, John C. *Options, Futures, and Other Derivatives. Seventh Edition*. New Jersey: Pearson Practice Hall, 2009, p. 99-101. ISBN 978-0-13-601586-4.

3.5.3 Tax Policy Definition of Tax Hybrid Transfers

For tax policy reasons, the OECD mentions hybrid transfers in two documents. Firstly, the Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues Report[439] defines hybrid transfers as "*arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralized loan*". The report mentions hybrid transfers as the example of *foreign tax credit generators*.[440] Similarly, the OECD/G20 Base Erosion and Profit Shifting Project Action 2: 2015 Final Report defines hybrid transfers as "*any arrangement to transfer a financial instrument where, as a consequence of the economics of the transaction and the way it is structured, the laws of two jurisdictions take opposing views on who is the owner of the underlying return on the transferred asset.*"[441] The Action 2 Final Report considers hybrid transfers as a type of financial arrangement. In particular, "*arrangements involving the transfer of financial instruments where differences in the tax treatment of that arrangement result in the same financial instrument being treated as held by more than one taxpayer.*"[442] Slight difference between the theoretical definitions and the definition for the OECD tax policy purposes is that the Action 2 Final Report discerns between hybrid financial instruments, hybrid transfers, and substitute payments.[443] However, according to the Action 2 Final Report hybrid transfers should be considered as financial instruments and thus should be covered by rules dealing with hybrid financial instruments[444], "*regardless of how the hybrid transfer is characterized under local law.*"[445] This approach to hybrid transfers in the OECD BEPS Action 2 Final Report leads to the interpretation that the OECD considers hybrid transfers for tax policy reasons as a financial instrument involving the transfer of financial instrument(s). This also leads to the interpretation that the OECD excludes financial leasing and other *double-dipping* arrangements from its scope.[446]

3.5.4 EU Law Definition of Tax Hybrid Transfers

The ATAD defines hybrid transfers as "*any arrangement to transfer a financial instrument where the underlying return on the transferred financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to that arrangement.*"[447] As stated above, the financial instrument for the ATAD purposes means "*any instrument to the extent that it gives rise to a financing or equity return that is taxed under*

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[439] OECD, ref. n. 329, p. 9-10.
[440] OECD, ref. n. 329, p. 9-10.
[441] OECD, ref. n. 20, p. 26.
[442] OECD, ref. n. 20, p. 25.
[443] OECD, ref. n. 20, p. 25.
[444] Recommendation 1 of the Action 2 Final Report.
[445] "*Recommendation 1 deems this type of asset transfer to be financial instrument so that the D/NI outcome arising under such an arrangement falls within the scope of the hybrid financial instrument rule, regardless of how the hybrid transfer is characterised under local law*". OECD, ref. n. 20, p. 26.
[446] LAW, Shee Boon and Marjolein KINDS, ref. n. 425, p. 147.
[447] Article 2(9)(l) of the ATAD.

the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer."[448] The ATAD also uses a specific definition of on-market hybrid transfer which "*means any hybrid transfer that is entered into by a financial trader in the ordinary course of business, and not as part of a structured arrangement.*"[449] The ATAD defines on-market hybrid transfers to exclude them for some term from its linking rules because the EU understands that hybrid transfers mostly take place for legitimate economic reasons and that an application of the ATAD's linking rules in these cases would be too damaging for financial markets.[450]

3.6. Branch Mismatches

3.6.1 Tax Theory Definition of Branch Mismatches

Branch mismatches differ from previously described situations because they are technically not *hybrid* mismatches. On the one hand, branch mismatches are similar to hybrid entities, debt-equity hybrid financial instruments, and tax hybrid transfers because they also arise due to a mismatch of applicable rules which can lead to D/NI, DD, and/or imported outcome. On the other hand, permanent establishments themselves exist only because of rules assigning right to tax between relevant countries and thus cannot have any internal hybrid element. Branch mismatches thereby are not a subset of hybrid mismatches.[451]

The term branch mismatch entails situations where one jurisdiction recognizes a permanent establishment whereas another jurisdiction does not. The OECD in the Action 2 branch mismatches report states that "*branch mismatches occur where the residence jurisdiction (i.e. the jurisdiction in which the head office is established) and a branch jurisdiction (i.e. the jurisdiction in which the branch is located) take a different view as to the allocation of income and expenditure between the branch and head office and include situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction. Branch mismatches are a product of inconsistencies in the domestic rules for determining the amount of income and expenditure subject to tax in each jurisdiction where the taxpayer operates*".[452]

The OECD Report identifies five situations[453] where branch mismatch occurs, *i.e.* disregarded branch structure, diverted branch payments, deemed branch payments, DD branch payments, and imported branch payments.[454]

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[448] Article 2(9)(j) of the ATAD.
[449] Article 2(9)(m) of the ATAD.
[450] Article 2(9)(a) in connection with Article 9 of the ATAD.
[451] Nevertheless, due to the objection to hybrid element I have described above is this rather a theoretical issue. Also, the IBFD Glossary does not define branch (PE) mismatches but includes them among hybrid mismatches.
[452] OECD, ref. n. 59, p. 9.
[453] OECD, ref. n. 59, p. 10.
[454] The academic literature on branch mismatches is rather scarce. For a brief discussion about branch mismatches under the ATAD see *e.g.* PANCHAM, Suniel. Chapter 19 – Permanent Establishment Mismatches under ATAD II.

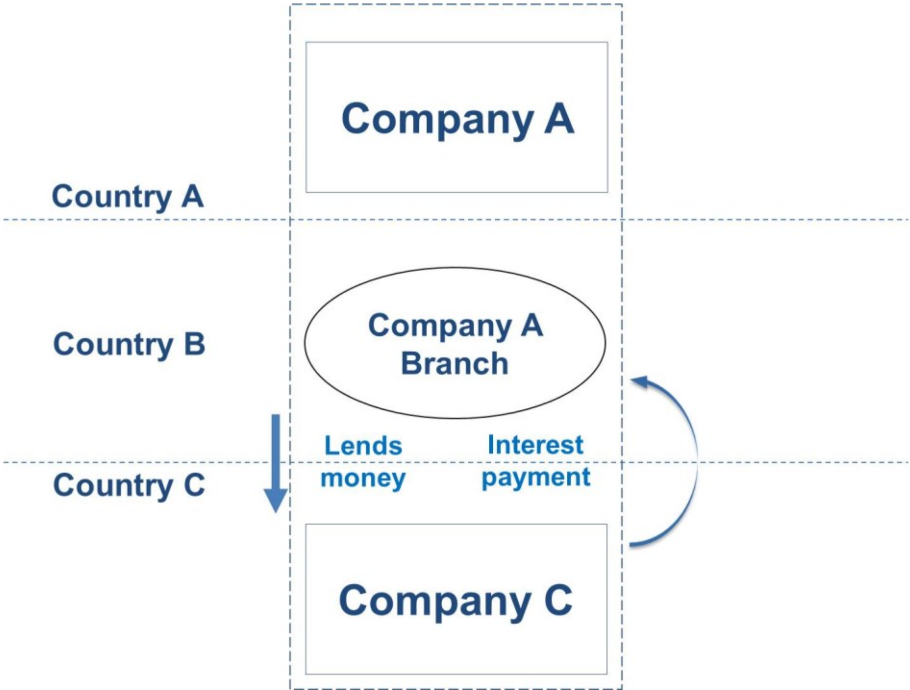
3.6.2 Model Examples and Possible Outcomes of Branch Mismatches

In general, the 2017 branch mismatches report includes many detailed examples.[455] For the purpose of illustration, I show a disregarded branch structure, deemed branch payments, and DD branch payments.

3.6.2.1 Disregarded Branch Structure

A Company A (a taxpayer and tax resident in Country A) has a branch in Country B and is an owner of Company C (a taxpayer and tax resident in Country C).[456] Company A lends money to Company C through the branch in Country B. The Company C then pays interest arising out of the loan to the branch (see Figure 19).

Figure 19 *Disregarded Branch Structure Scenario*



For the purpose of this study, I discuss only three scenarios but more scenarios are possible.

The first scenario does not include a mismatch (see Figure 20). Country A and B recognize the branch (the Company A has a taxable presence in Country B). Country C allows interest deduction by the Company C and Country B taxes that interest income of the branch. Country A

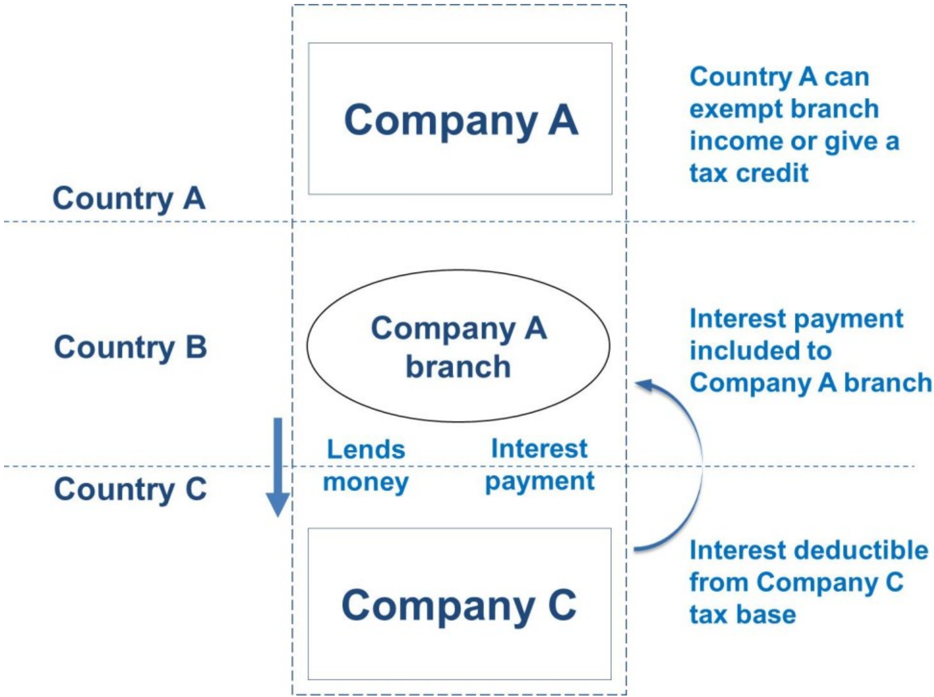
PISTONE, Pasquale and Dennis WEBER, ed. *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study*. Amsterdam: IBFD, 2018, p. 419-436. ISBN 978-90-8722-446-2. For a discussion of use of permanent establishments in tax structuring and its relation to the BEPS Actions 1 and 7 (artificial avoidance of PE status) see *e.g.* BETTEN, Rijkele and Monia NAOUM, ref. n. 63, p. 43-68. For an analysis of the concept of the PE itself see KOBETSKY, Michael, ref. n. 63.

[455] Examples 1-11. OECD, ref. n. 59, p. 57-99.

[456] OECD, ref. n. 59, p. 14-15.

recognizes that Country B taxes Company A's branch and prevents double taxation of interest income by exemption method.

Figure 20 *Illustration of the First Scenario without a Branch Mismatch*



The second scenario includes a mismatch leading to a D/NI outcome. Country A recognizes the branch in Country B and exempts its interest income from taxation (see Figure 21). But Country B does not tax the branch because the branch does not give rise to taxable presence under Country B's tax law (see Figure 22). Country C thus allows Company C to deduct interest (deduction) but neither Country B nor A include interest income to Company A's tax base (non-inclusion), *i.e.* the D/NI outcome (see Figure 23).

Figure 21 *Illustration of the Second Scenario with a Branch Mismatch: Country A Perspective*

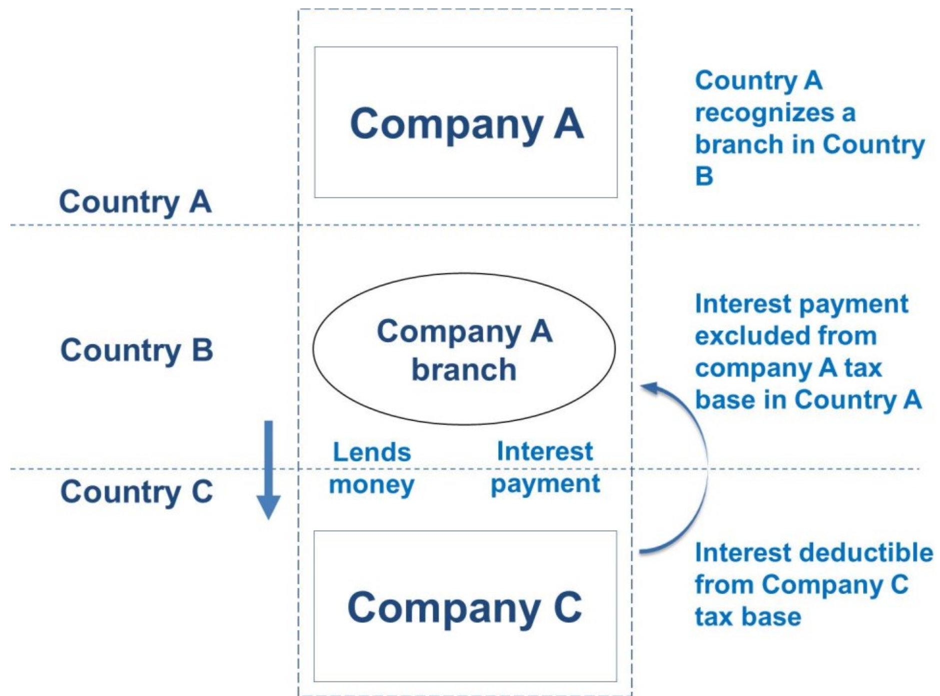


Figure 22 *Illustration of the Second Scenario with a Branch Mismatch: Country B Perspective*

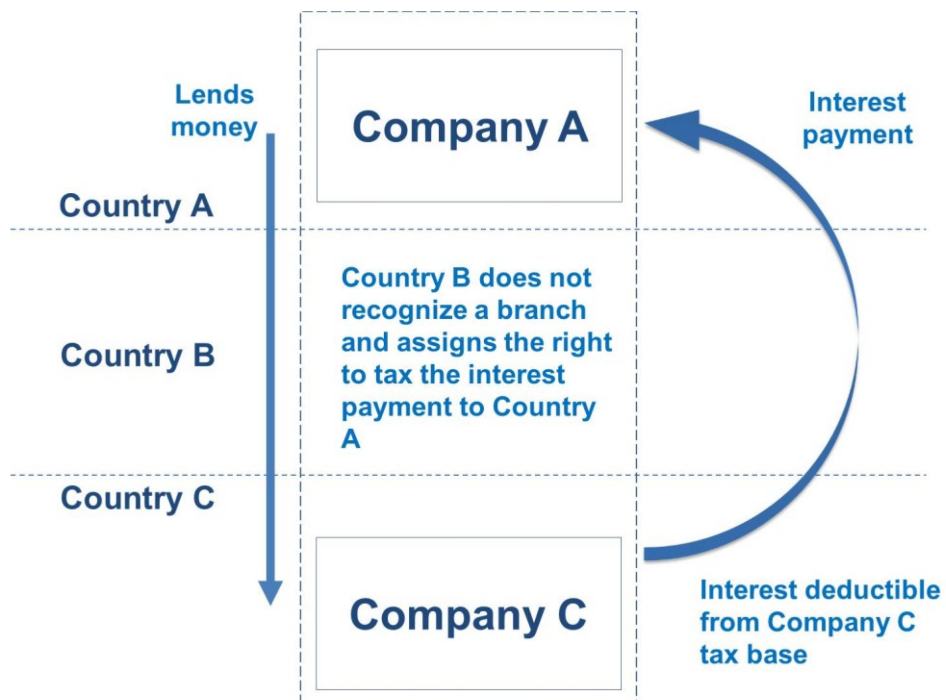
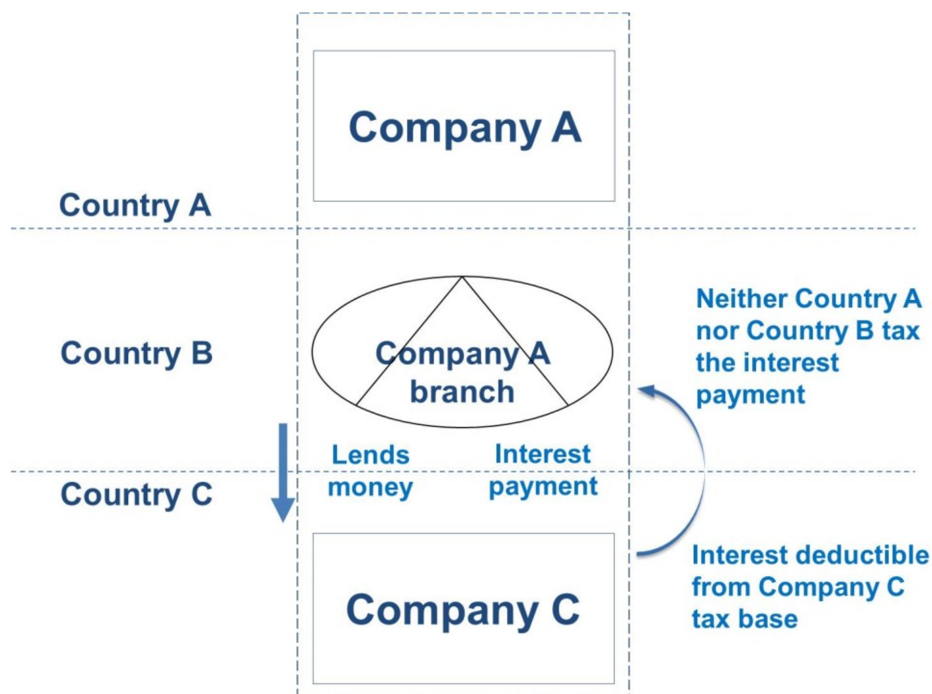


Figure 23 *Illustration of the Second Scenario with a Branch Mismatch: Perspective of Both Countries*



The third scenario also includes a mismatch leading to a D/NI outcome. Country A and B have concluded a double tax treaty which contains a provision on permanent establishment. The branch in Country B fulfills the criteria for the permanent establishment under the double tax treaty between these two countries. The Country A therefore exempts the branch's interest income from taxation. However, the Country B has a definition of permanent establishment in its domestic legal system that differs from the treaty definition. Therefore, Country B does not recognize the branch as a permanent establishment and thus as a taxable entity and does not include interest income into Company A's tax base. Country C thus allows Company C to deduct interest (deduction). However, neither Country B nor A include interest income to Company A's tax base (non-inclusion), *i.e.* the D/NI outcome.

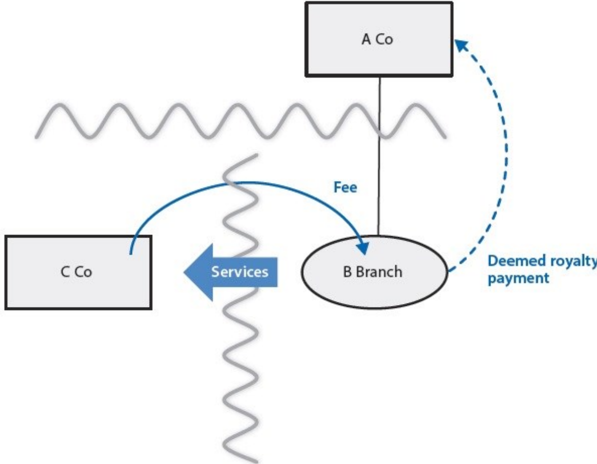
3.6.2.2 Deemed Branch Payments

A Company A (a taxpayer and tax resident in Country A) has a branch in Country B. The branch has an unrelated customer Company C (a taxpayer and tax resident in Country C).[457] Company A supplies services to Company C using the branch and exploiting intangibles owned by Company A. Country B attributes the ownership of those intangibles to Company A and treats the branch as if it made an arm´s length payment to Company A to compensate it for the use of its intangibles. The branch can thus deduct the deemed royalty payment from its tax base but the

[457] OECD, ref. n. 59, p. 16-17.

Country A does not recognize such deemed payment because it attributes the ownership of intangibles to the branch and subsequently exempts the income of the branch. Therefore, this scenario leads to D/NI outcome because mismatch in attributing the ownership of intangibles leads to the deduction of royalties in Country B but does not lead to the recognition of the royalty payment in Country A.

Figure 24 *Deemed Branch Payments Illustration*[458]



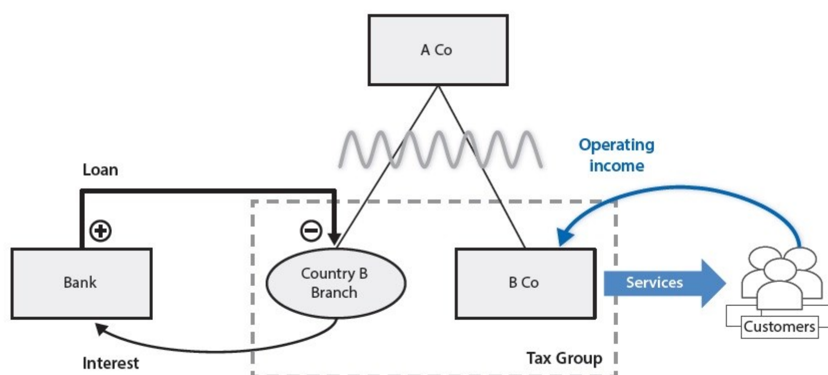
3.6.2.3 DD Branch Payments

The OECD Action 2 Branch Report mentions two situations where DD branch payments can arise.[459] The first situation is where the residence jurisdiction allows "*the residence jurisdiction provides head office an exemption for branch income while permitting it to deduct the expenditure attributable to the branch*".[460]

Company A (tax resident of Country A) has both, a branch and a subsidiary, in Country B. Country B allows for a group taxation and its laws permit the branch and the subsidiary to create a group for income tax purposes. Thus, the expenditures of the branch may be offset against the income of the subsidiary (and vice versa). Then, if the branch has, for instance, an interest expenditure, the subsidiary can deduct this expenditure from its taxable operating income. However, Country A may recognize the branch as taxable. In such a case, the Company A can deduct the branch interest expense against its income, too. That would lead to double deduction without an inclusion of any corresponding income because the branch has no taxable income that would be included.

[458] OECD, ref. n. 59, p. 16.
[459] OECD, ref. n. 59, p. 17-18.
[460] OECD, ref. n. 59, p. 17.

Figure 25 *DD Branch Payments Illustration*[461]



3.6.3 Tax Policy Definition of Branch Mismatches

The OECD BEPS Project Action 2 2015 Report does not deal with branch mismatches.[462] The OECD has decided to issue a stand-alone report Neutralising the Effects of Branch Mismatch Arrangements which is a part of the OECD BEPS Project Action 2.[463] This report compares branch mismatch arrangements with hybrid entity situations and concludes that also hybrid branches may lead to DD and D/NI outcomes.[464] The Report implicitly distinguishes *hybrid* mismatches that exist due to *hybrid element* from branch mismatches that exist due to the mismatch of domestic branch rules of the residence jurisdiction, the jurisdiction where the head office resides, and a branch jurisdiction, the jurisdiction where the branch is located.[465]

As I have written above, the term branch mismatch arrangements denotes under the OECD BEPS Project Action 2 five basic types of branch mismatches, *i.e.* (i) disregarded branch structures, (ii) diverted branch payments, (iii) deemed branch payments, (iv) DD branch payments, and (v) imported branch mismatches.

3.6.4 EU Law Definition of Branch Mismatches

The Council had proposed the ATAD before the OECD published the branch report. The ATAD deals with branch mismatches anyway.[466] The directive[467] deals explicitly with three types of permanent establishment (branch) mismatches leading to deductions without corresponding

[461] OECD, ref. n. 59, p. 18.
[462] OECD, ref. n. 20.
[463] OECD, ref. n. 59.
[464] OECD, ref. n. 59, p. 9.
[465] See *e.g.* the OECD stating that "*Branch mismatch arrangements* (…) *raising the same issues as hybrid mismatches* (…)". OECD, ref. n. 59, p. 10.
[466] The branch report actually references to the ATAD. OECD, ref. n. 59, p. 12.
[467] Article 2(9)(c), (d) and (f) of the ATAD.

inclusions, namely (i) allocation mismatches; (ii) disregarded permanent establishment mismatches, and (iii) deemed payment mismatches.[468] The ATAD also deals implicitly with DD outcomes due to the branch mismatch[469] and with imported branch mismatches[470]. The ATAD does not contain any definition of permanent establishment.[471]

3.7. Imported Hybrid Mismatches

3.7.1 Tax Theory Definition of Imported Hybrid Mismatches

As I have described above, the hybrid mismatches and branch mismatches can create D/NI and DD outcomes. However, countries have already enacted rules dealing with these situations for example because they consider hybrid mismatches a tax policy issue.[472] To circumvent rules dealing with hybrid mismatches, tax practitioners can create an arrangement leading to D/NI or DD outcome using hybrid mismatch between countries that do not have anti-hybrid mismatches rules and then import (transfer) this outcome to a jurisdiction that has anti-hybrid mismatches rules. To achieve this result, tax practitioners firstly create a D/NI or DD outcome using, for instance, techniques I have described earlier and then they use set of arrangements, usually in a form of back-to-back loans[473], to import the outcome to the jurisdiction that has anti-hybrid mismatches rules.

3.7.2 Model Examples and Possible Outcomes of Imported Hybrid Mismatches

The OECD BEPS Action 2 provides several examples of imported hybrid mismatches with a detailed description.[474]

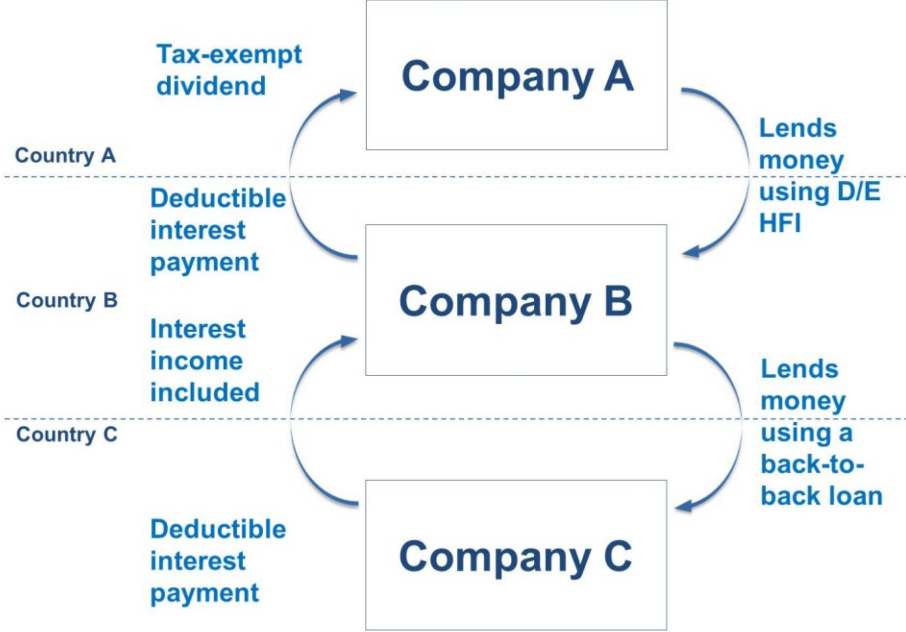
3.7.2.1 Imported Hybrid Mismatch Outcome Using Debt-Equity Hybrid Financial Instrument

An internationally operating group consisting of three companies wants to lower its overall tax duty.[475] A Company A (a taxpayer and tax resident in Country A) owns a Company B (a taxpayer

[468] PANCHAM, Suniel, ref. n. 454, p. 435.
[469] Article 2(9)(g) of the ATAD.
[470] Article 9(3) of the ATAD.
[471] PANCHAM, Suniel, ref. n. 454, p. 435.
[472] See *e.g.* LAW, Shee Boon and Marjolein KINDS, ref. n. 425, p. 137-142.
[473] The IBFD Tax Glossary defines a back-to-back loan as an "*informal term to describe indirect lending arrangements under which funds are lent through an intermediary that enters into separate but symmetrical loan agreements with the lender, on the one hand, and the borrower, on the other. May also describe more loose arrangements where, e.g. one party guarantees a loan made by an unrelated financial institution to another party. The ultimate lender and borrower are typically related parties, e.g. members of the same corporate group. Back-to-back loans may be used in order to circumvent, e.g. thin capitalization rules, or as a treaty shopping device to obtain the benefit of more favourable withholding tax rates*". Arnold adds that "*Back-to-back arrangements are commonly used as a tax planning device to obtain tax benefits that would not otherwise be available to a taxpayer directly*". ARNOLD, Brian J., ref. n. 299, p. 113. It is worth noting that in the Czech Republic two or more persons concluding back-to-back loan to lower their tax duty or to increase their tax loss, constitute *otherwise related persons* under the § 23(7)b)5 of the CITA. Thus, transfer pricing rules automatically apply in such cross-border as well as domestic scenarios under the § 23(7) of the CITA.
[474] See examples 8.1-16. OECD, ref. n. 20, p. 341-422.

and tax resident in Country B) that owns a Company C (a taxpayer and tax resident in Country C). Country A and Country C are high tax jurisdictions whereas Country B is a low-tax jurisdiction. Country A and B have not enacted linking rules dealing with D/E HFIs yet but Country C has already enacted rules tackling D/E HFIs. Thus, the group cannot use D/E HFI between Company B and C for tax planning purposes because the tax benefit would be neutralized by Country C's anti-hybrid mismatches rules. Therefore, the Company A provides a loan to the Company B using a D/E HFI. Company B immediately concludes the same contract with the Company C (see Figure 26).

Figure 26 *D/E HFI Imported Mismatch Scenario*



This structure leads to an interest deduction by the Company C in Country C. Then, Company B includes the income in the Country B but since the Company B also has an interest deduction, the resulting tax base of Company B is net zero because the outgoing payment is deducted from the incoming payment. Country A treats the payment as a dividend payment and exempts it. The structure does not trigger the Country C's anti-D/E HFI rule because the sole agreement between Company B and Company C does not include any hybrid mismatch.

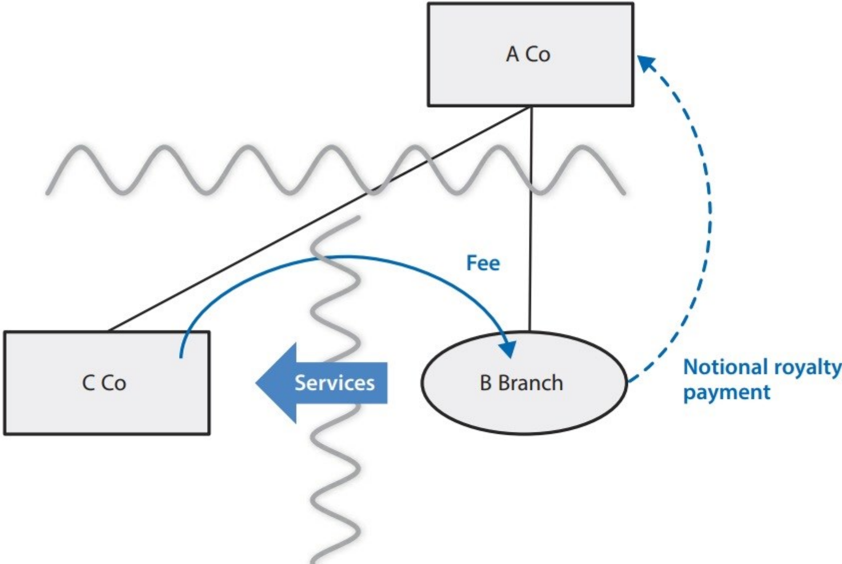
3.7.2.2 Imported Branch Mismatch Outcome

Company A (tax resident in Country A) has a branch in Country B and a wholly owned subsidiary Company C (tax resident in Country C).[476] The branch provides services to Company C

[475] For an example including applicability of linking rules in such circumstances see the example 8.3. OECD, ref. n. 20, p. 341-422.
[476] OECD, ref. n. 59, p. 18-19, 98-99.

for a fee and exploits intangibles owned by Company A. Country B attributes the ownership of those intangibles to Company A and treats the branch as if it made an arm´s length payment to Company A to compensate it for the use of its intangibles. The branch can thus deduct the deemed royalty payment from the service fee paid by Company C. The Country A does not recognize the deemed payment because it attributes the ownership of intangibles to the branch and subsequently exempts the income of the branch. Therefore, this scenario leads to D/NI outcome because mismatch in attributing the ownership of intangibles leads to deduction of royalties in Country B but does not lead to recognition of a royalty payment in Country A.

Figure 27 *Imported Branch Mismatch Example Illustration*[477]



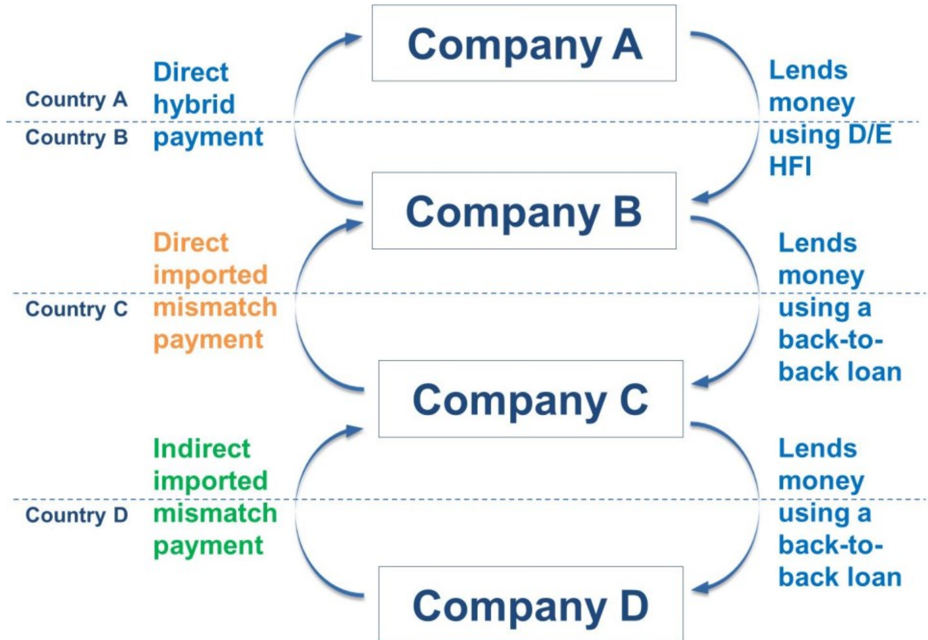
3.7.3 Tax Policy Definition of Imported Hybrid Mismatches

The OECD BEPS Action 2 Final Report does not define imported hybrid mismatch explicitly. Instead, the Report lays down a recommended rule and adds its description.[478] Thus, the definition of imported hybrid mismatch for the OEDC BEPS Action 2 purposes is that imported hybrid mismatches are all situations covered by the Recommendation 8 of Action 2. To deal with imported hybrid mismatches, the final report uses a definition of hybrid deduction[479] to narrow the scope of the rule applicable to imported mismatch payment.[480] In general, hybrid deduction means

477 OECD, ref. n. 59, p. 98.
478 OECD, ref. n. 20, p. 83-91.
479 Recommendation 8.2.
480 Recommendation 8.3.

situations including hybrid mismatch arrangement leading to a D/NI or DD outcome.[481] The final report thereby deals with payments that ultimately lead to funding a hybrid mismatch arrangement. The final report divides these payments into direct and indirect imported mismatch payments (see Figure 28).[482] Overall, the final report distinguishes between situations when a payment is part of a structured arrangement, leads directly to hybrid mismatch arrangement, or leads indirectly do hybrid mismatch arrangement.[483]

Figure 28 *Explanation of Terminology of Imported Hybrid Mismatches Rules*



3.7.4 EU Law Definition of Imported Hybrid Mismatches

The ATAD defines imported hybrid mismatch payment as "*any payment by a taxpayer to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions between associated enterprises or entered into as part of a structured arrangement except to the extent that one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect of such hybrid mismatch*".[484] Thus the imported hybrid mismatch rule similarly to the OECD linking rule needs three elements to apply, *i.e.* (i) the payment must fund

481 Recommendation 8.2. See also ALLEN, Christina. The Difficult Imported Mismatch Rules: BEPS Action 2 Recommendations. *Derivatives & Financial Instruments*. 2017, 19(6), p. 1 [online]. ISSN 1389-1863.
482 OECD, ref. n. 20, p. 84-85.
483 OECD, ref. n. 20, p. 83-85.
484 Article 9(3) of the ATAD.

a hybrid mismatch, (ii) there must be a nexus between the payment and the deduction (nexus), and (iii) no other linking rule applies.[485]

3.8. Summary and Conclusion

To sum up, I have shown in this chapter that two groups of mismatches (hybrid mismatch arrangements and branch mismatches) exist and that these mismatches can have either negative outcomes for taxpayers, *i.e.* multiple taxation, or beneficial outcomes for a taxpayer, *i.e.* non-taxation through the D/NI and DD outcomes. I have shown that hybrid mismatch arrangements divide into three groups, *i.e.* hybrid entities, D/E HFIs, and tax hybrid transfers and that tax planners can use back-to-back loans to shift benefits of these arrangements to other jurisdictions, and that these structures lead to lowering of their overall tax burden.

Chapters 2 and 3 have also shown that hybrid mismatch arrangements unique to cross-border situations and that they bring difficulties to designing a tax system because tax law rules dealing with categorizing reality lead to situations of no coordination between two or more jurisdictions.

Examples of outcomes of hybrid mismatches have also shown that hybrid mismatch arrangements may lead to cases of no taxation and to cases of multiple taxation. However, the question is – so what? Are these outcomes good, bad, or perhaps ugly? Why do tax policymakers want to deal with these outcomes? And does it make sense from a normative perspective? I deal with the answer in the next chapter which dives into the big debate – does the single tax principle really exist?

[485] For a discussion about branch mismatches under the ATAD, see *e.g.* PEETERS, Bart. Chapter 20 – Imported Mismatches. PISTONE, Pasquale and Dennis WEBER, ed. *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study*. Amsterdam: IBFD, 2018, p. 437-451. ISBN 978-90-8722-446-2.

4. Much Ado About Nothing? The Outcomes of Hybrid Mismatches

4.1. Introduction

As I illustrated in Chapter 3, the hybrid mismatches are results of different characterization for income tax purposes of reality by two or more countries in cross-border transactions. Mischaracterizations of taxpayers, payments, and ownership can lead to non-taxation or multiple taxation. Normative views on how many times and how much should countries tax single income range from agnostics claiming that any normative claim about taxing income on the continuum of all possible combinations of taxation is impossible to proponents of the single tax principle.

The purpose of Chapter 4 is to put the outcomes of hybrid mismatches into the tax policy context and to explain why tackling hybrid mismatches may be significant for countries and taxpayers. I show in this chapter that scholars have not yet come up with a definite normative assessment of how much and how many times countries should tax cross-border income. Since this discussion is not over thus far, I conclude that countries are basically free to structure their tax policy views within their legal constraints and to subject a cross-border income to taxation as part of their tax policy. Countries therefore have the liberty to declare hybrid mismatches as unwanted from their tax policy perspective and can enact rules eliminating hybrid mismatches and the outcomes. This is important for the following chapters arguing how countries, which want to foster the single tax principle as part of their tax policy, may do so without using linking rules. The discussion in this chapter should also prepare grounds for the argument I am proposing in the following chapter that recent developments in the OECD tax policy that has affected the EU directives dealing with hybrid mismatches rules fortify the position of the *formal* single tax principle as a legal principle governing only some hybrid mismatches, *i.e.* hybrid mismatch arrangements within the scope of the OECD BEPS Action 2, and that any legal regulation dealing with hybrid mismatches in EU Member States within the scope of the ATAD must achieve at least *formal* single taxation.

To argue that, the chapter deals with all ranges of possible taxation of one income, *i.e.* non-taxation, single taxation, and double and multiple taxation. Firstly, in accordance with the historical development, I discuss double taxation, means of its alleviation, and current normative assessment. To deal with the normative assessment, I tap into the debate about the single tax principle. Subsequently, I show what double non-taxation is, its current normative assessment, and means of its alleviation. The last part of the chapter argues that single taxation is a relevant tax policy goal and that countries can tax hybrid mismatch arrangements outcomes.

4.2. Double Taxation, Its Normative Assessment, and Forms of Its Alleviation

As I described in Chapter 2, countries have generally great liberty in designing their domestic tax system and face only the few legal limits in exercising their right to tax because public international law limits the right to tax only to a small extent.[486] States use various criteria including, for example, residence and source to establish what income is taxable under their domestic tax law. Thus, two or more countries can consider one person as their tax resident depending on what criteria they use to establish tax residency and/or one income can have legal sources in more countries. These situations are examples of juridical double taxation. The term juridical double taxation traditionally[487] means that "*the same income or capital is taxable in the hands of the same person by more than one State*".[488] Types of conflicts leading to juridical double taxation are (i) residence-residence conflict, (ii) source-source conflict, and (iii) residence-source conflict.[489] The first group of double taxation cases means that two (or more) countries view one taxpayer as their tax resident. If these countries use worldwide income taxation of their tax residents, they can tax one income twice or several times. The second group incorporates situations where one income has a source in two or more jurisdictions based on their relevant tax laws. The last group consists of cases where tax resident of one country derives income which has a source in another country. In such a case, countries may tax income due to residence of the taxpayer as well as due to the place of source of her income.

Double tax treaties mainly deal with cases where one taxpayer is taxed twice, *i.e.* with juridical double taxation.[490] Nonetheless, states can sometimes in double tax treaties deal with situations of taxing one income of two or more taxpayers, *i.e.* economic double taxation.[491] Economic double taxation is a situation "*where two different persons are taxable in respect of the same income or capital*".[492] The

[486] For a brief summary see also *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 306. ; LANG, Michael, ref. n. 210, p. 27.

[487] Ismer and Ruß state that the term juridical double taxation can be tracked back to Herbert Dorn using it in 1927 and that his definition corresponds with the OECD Model DTC definition. ISMER, Roland and Julia RUSS. What Is International Double Taxation? *Intertax*. 2020, 48(6/7), p. 556-557.

[488] OECD, ref. n. 66, p. 376.

[489] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 21-23. ; Double Taxation. RUST, Alexander. *Double Taxation within the European Union*. The Netherlands: Wolters Kluwer International, 2011, p. 1-2. ISBN 978-9041135254.

[490] See OECD, ref. n. 488, p. 376, par. 1.

[491] In regard to bilateral solution of double economic taxation of dividends by double tax treaties see OECD, ref. n. 488, p. 395-396, par. 50-54. As concerns double economic taxation of associated enterprises because of transfer pricing see OECD, ref. n. 488, p. 226-230. ; OECD. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*. Paris: OECD Publishing, 2017. DOI: https://dx.doi.org/10.1787/tpg-2017-en. ISBN 978-92-64-26273-7. Available at: https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page1.

[492] OECD, ref. n. 488, p. 376, par. 2.

common example of double economic taxation is taxation of distributed dividends.[493] Firstly, profits are taxed at the level of corporation under corporate income tax. Then, distributed dividends are taxed again at the shareholder´s level under individual or corporate income tax.[494]

Normative assessment of the double taxation is not as clear as it *prima facie* looks like and the assessment is a mixture of tax theory and tax policy statements and thoughts. To entangle this issue, I firstly approach it from the historical perspective, showing how countries in general dealt with double taxation and then I discuss how contemporary scholars view double taxation and what implications of this discussion are.

The normative question of whether countries should prevent double taxation or not arose immediately when countries started imposing income taxation on cross-border income.[495] Traditionally, taxpayers and tax policymakers have viewed double taxation as an undesirable outcome.[496] Hence they tried to find a solution to alleviate the impacts of double taxation. Tax policymakers and scholars discussed such solutions from the international perspective as well as from the perspective of individual states.

From the international perspective, states have traditionally concluded double tax treaties to deal with double taxation[497] by allocating their taxing rights and using the exemption method.[498] Obviously, states which exported capital (*creditor states*) preferred the principle of residence taxation whereas states which imported capital (*debtor states*) preferred the principle of source taxation.[499] This created tension between states concluding double tax treaties and a centralized approach toward double taxation had not existed before the beginning of World War I.[500] After the Great War,

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493 See *e.g.* MARIO, Terone. Chapter 5 – The Parent-Subsidiary Directive. LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ed. *Introduction to European Tax Law on Direct Taxation: 5th edition*. Austria: Linde, 2018, p. 144. ISBN 978-3-7073-3846-1.

494 For a brief discussion of economic double taxation in corporate settings and why it can lead to the debt-bias, see *e.g.* SCHWARZ, Stephen and Daniel J. LATHROPE, ref. n. 160, p. 115-117.

495 AVI-YONAH, Reuven S., ref. n. 95, p. 3.

496 Christians writes that the "*resulting double taxation was considered a collective action problem: a clear threat to national economic interests that might only be solved by global cooperation*". CHRISTIANS, Allison. BEPS and the Power to Tax. CHRISTIANS, Allison and Sergio Andre ROCHA. *Tax Sovereignty in the BEPS Era*. Alphen aan den Rijn, The Netherlands: Wolters Kluwer International, 2017, p. 6. ISBN 978-9041167071. See also *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 3. ; DAGAN, Tsilly. *International Tax Policy: Between Competition and Cooperation*. Cambridge: Cambridge University Press, 2018, 2017-11-24, p. 45. ISBN 978-1-107-11210-0. ; ADAMS, Thomas S. International and Interstate Aspects of Double Taxation. In: *Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association*. 1929, p. 198.

497 AVI-YONAH, Reuven S., ref. n. 95, p. 3.

498 See on the history of tax treaties before 1914 *e.g.* JOGARAJAN, Sunita. Prelude to the International Tax Treaty Network: 1815-1914 Early Tax Treaties and the Conditions for Action. *Oxford Journal of Legal Studies*. 2011, 31(4), 679-707. DOI: 10.1093/ojls/gqr021. ISSN 0143-6503. Available at: https://academic.oup.com/ojls/article-lookup/doi/10.1093/ojls/gqr021.

499 WANG, Ke Chin. International Double Taxation of Income: Relief Through International Agreement 1921-1945. *Harvard Law Review*. 1945, 59(1), p. 114-116. DOI: 10.2307/1335505. ISSN 0017811X. Available at: https://www.jstor.org/stable/1335505.

500 AVI-YONAH, Reuven S., ref. n. 95, p. 3. ; DAGAN, Tsilly, ref. n. 496, p. 45.

European states raised statutory income tax rates to increase their tax revenues which intensified the double taxation issue for taxpayers and threatened to hinder international trade because taxpayers had to pay high income taxes twice.[501] The League of Nations and the International Committee of Commerce wanted to resolve the tension between capital exporting and capital importing states and to resolve the double taxation issue by proposing a draft double tax convention.[502] In 1920, the ICC issued its model tax convention draft based on "*a profit-split methodology*" as a basis for the allocation of tax revenues.[503] In 1921, the League of Nations Financial Committee "*entrusted the theoretical study of Double Taxation to four economists*",[504] namely Professor Bruins of Rotterdam, the Netherlands, Professor Senator Einaudi of Turin University, Italy, Sir Josiah Stamp of London University, the UK, and Professor Seligman of Columbia University, the US.[505] These economists represented capital exporting as well as capital importing countries.[506] They approached the double tax issue from a perspective of a hypothetical global tax policymaker who would try to establish an ideal international tax system.[507] In 1923, the panel published a final report which "*weighed several options for allocating taxing rights among residence countries, countries of citizenship, and source (or host) countries*".[508] The experts have concluded in the report that the ideal system of international taxation should consist of pure residence-based single taxation[509] and rejected the ICC approach.[510] However, such a solution

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[501] AVI-YONAH, Reuven S., ref. n. 95, p. 3. ; DAGAN, Tsilly, ref. n. 496, p. 45.

[502] WANG, Ke Chin, ref. n. 499, p. 73.

[503] WELLS, Bret and Cym H. LOWELL, ref. n. 11, p. 6. Profit splitting is one of the profit-based methods to deal with the problem of transfer pricing. The IBFD Glossary currently defines profit split method as the "*profit split method is a transfer pricing method that allocates the combined operating profit or loss from a transaction to associated enterprises in a manner that reflects the division of profits thatwould have been expected in an arm's length arrangement. This may include adivision based on the relative contribution of each participant to thetransaction. The relative value of each participant's contribution will normally be determined by taking into account the functions performed, risks assumed, and resources employed by the participant. There is a variety of profit split methods, including the comparable profit split method, the residual profit split method, and the total profit split method*". For a brief introduction to these terms, see *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 30-35.

[504] See also COMMITTEE OF TECHNICAL EXPERTS ON DOUBLE TAXATION AND TAX EVASION. *Double Taxation and Tax Evasion Report*. Geneva: League of Nations, 1927, p. 6. The Financial Committee also decided to appoint a panel of seven officials to study the problem of double taxation and tax evasion ("*flight of capital*") "*from an administrative and practical point of view*". *Ibid*, p. 6.

[505] DAGAN, Tsilly, ref. n. 496, p. 45.

[506] Avi-Yonah explains that the economists "*were not chosen randomly. Two were from capital importing countries, Italy and the Netherlands, which traditionally supported source-based taxation and believed that residence countries should cede jurisdiction to tax-to-source countries. One was from the UK, historically the major capital exporting country, and believed that source countries should cede jurisdiction to residence countries. The fourth, Professor Edwin Seligman of Columbia University, was from a country that used to be capital importing but had recently become the world's largest exporter of capital. In addition, that country (the US) had in 1918 become the first in the world to adopt a foreign tax credit, which unilaterally gave precedence to the source country tax. Seligman was therefore well positioned to mediate between the others.*" AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[507] DAGAN, Tsilly, ref. n. 496, p. 45.

[508] DAGAN, Tsilly, ref. n. 496, p. 45. See also Coates writing that "*what were the economic consequences of double taxation, and whether any general principles could be formulated as a basis for a general international convention, or separate conventions between particular countries, to remove its evil consequences*". COATES, W. H. League of Nations Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp. *Journal of the Royal Statistical Society*. Wiley (for the Royal Statistical Society), 1924, 87(1), p. 99.

[509] DAGAN, Tsilly, ref. n. 496, p. 45. ; AVI-YONAH, Reuven S. All of a Piece Throughout: The Four Ages of U.S. International Taxation. *Virginia Tax Review*. 2005, 25(2), p. 323.

was not practical because if the source country does not impose an income tax, the source country loses potential tax revenue.[511] Thus, the economic allegiance,[512] *i.e.* where are "*the true economic interests of the taxpayer*", [513] has become more important than the political allegiance for establishing a jurisdiction to tax.[514] Thus, to "*determine such interests, consideration must be given to the acquisition of wealth, the location of wealth, the enforceability of the right to wealth, and residence or domicile*".[515] The report then discussed "*various categories of wealth and income*"[516] and came to the conclusion that one taxpayer can have an economic allegiance, necessary to establish tax jurisdiction over an income, to the source jurisdiction, where the income is produced, and the residence jurisdiction, where the income is consumed or saved.[517] One taxpayer thus can have allegiance toward more countries – more source jurisdictions.[518] The report suggests as a solution "*that states split the revenues by reciprocally waiving their rights to tax*"[519] using either the exemption method or the credit method.[520] Classification of income and division of taxing rights (source-based taxation) using tax treaties was only a temporary solution.[521] Avi-Yonah summarizes the report stating that the report has two major contributions.[522] The first contribution is the "*first bite at the apple*" rule and the second one is the benefits principle.[523] The former states that "*between residence and source the rights of the source country must prevail because, since the income arises within the source country, the residence country cannot prevent the source country from taxing that income*".[524] The latter states that "*active (business) income should be taxed primarily at source while passive (investment) income should be taxed primarily on a residence basis*".[525] The final report containing the first bite at the apple rule and the benefits principle has become a cornerstone for following drafts of model tax treaties and a subsequent system of bilateral tax treaties based on these model treaties[526], which

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[510] Wells and Lowell call this a "*colossal mistake*". WELLS, Bret and Cym H. LOWELL, ref. n. 11, p. 6. It is also paradoxical because now it seems that the profit-split method could become a dominant method of corporate taxation.

[511] AVI-YONAH, Reuven S. Structure of International Taxation: A Proposal for Simplification. *Texas Law Review*. 1996, 74(6), p. 1306.

[512] See also *e.g.* AVI-YONAH, Reuven S., ref. n. 509, p. 1305.

[513] WANG, Ke Chin, ref. n. 499, p. 82.

[514] WANG, Ke Chin, ref. n. 499, p. 81. This has however been changing, Christians points out that politicians and civil society activists currently promote nationality and political allegiance as the more important aspect. CHRISTIANS, Allison, ref. n. 496, p. 11-12.

[515] WANG, Ke Chin, ref. n. 499, p. 81.

[516] DAGAN, Tsilly, ref. n. 496, p. 46.

[517] AVI-YONAH, Reuven S., ref. n. 512, p. 1305-1306.

[518] DAGAN, Tsilly, ref. n. 496, p. 46.

[519] DAGAN, Tsilly, ref. n. 496, p. 47.

[520] AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[521] AVI-YONAH, Reuven S., ref. n. 509, p. 313.

[522] AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[523] AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[524] AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[525] AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[526] Wells and Lowell summarize five principles that were later embodied into the OECD and UN DTC Models. See WELLS, Bret and Cym H. LOWELL, ref. n. 11, p. 27.

creates the international tax regime, as some argue.[527] However, in practice, double tax treaties have not strictly adhered to these underlying principles and the reality of tax treaties is complex.[528] Moreover, the 1920s compromise has set up the foundations current international tax system and influenced its trajectory until now. Changing the system that is surprisingly harmful to capital exporting countries as well as capital importing countries, is an uphill battle because the past is still present[529] and the tension between these groups of countries is difficult to solve.[530]

From the state's perspective, tax policymakers in a closed economy should strive for promoting economic efficiency and distributive justice (equity).[531] Maximizing the efficiency in the closed economy traditionally means attaining tax neutrality, *i.e.* taxation should not lead to economic agents altering their behavior while raising revenues for government and minimizing the *deadweight loss*.[532] Under these conditions, the free market should theoretically lead to the best possible allocation of assets while the government can use the money to maximize the social welfare function (equity).[533] Unfortunately, income taxation without distortion is practically impossible.[534] In an open economy, tax policymakers who dealt with international taxation used to emphasize benefits and fairness.[535] But, after the Richman's dissertation[536], the discussion shifted toward achieving economic

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[527] See *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 4-5. ; COMMITTEE OF TECHNICAL EXPERTS ON DOUBLE TAXATION AND TAX EVASION, ref. n. 504, p. 5-18. ; WANG, Ke Chin, ref. n. 499, p. 81-97. ; GRAETZ, Michael J. and Michael M. O'HEAR. The "Original Intent" of U.S. International Taxation. *Duke Law Journal*. 1997, 46(5), p. 1023. Available at: https://scholarship.law.duke.edu/dlj/vol46/iss5/2.

[528] See *e.g.* WANG, Ke Chin, ref. n. 499, p. 102-114.

[529] For example, Ault warns not to "*underestimate the inertia effect resulting from the existing domestic tax rules and treaties*". AULT, Hugh J. Some Reflections on the OECD and the Sources of International Tax Principles. *Tax Notes International*. 2013, 2013(June 17), p. 1201.

[530] For example, Kysar quoting Devereux and others and the OECD argues that even the OECD proposes reforms that are conflicting each other saying that the aim of the BEPS Project is to tax income somewhere (this applies also to hybrid mismatch arrangements, see Chapter 5) whereas the Pillar I "*attempts to reallocate some taxing rights to*" the market (capital importing) country because current winners are "*the production jurisdictions*". KYSAR, Rebecca M., ref. n. 12, p. 217, 220.

[531] Kaplow writes "*any standard social welfare function will favor a reform package that increases efficiency while leaving distribution unaffected*". KAPLOW, Louis. *The Theory of Taxation and Public Economics*. New Jersey: Princeton University Press, 2008, p. 3. ISBN 978-0-691-14821-2. ; Dagan writes that "*Income tax is traditionally regarded as a vehicle for allocating the costs of government in an equitable and efficient manner*". DAGAN, Tsilly. *International Tax Policy: Between Competition and Cooperation*. Cambridge: Cambridge University Press, 2018, 2017-11-24, p. 15. ISBN 978-1-107-11210-0. For the description of this, see *e.g. ibid*, p. 15-19. ; AVI-YONAH, Reuven S. Why Tax the Rich? Efficiency, Equity, and Progressive Taxation. *Yale Law Journal*. New Haven, CT, 2002, 111(6), p. 1413-1416.

[532] See DAGAN, Tsilly, ref. n. 531, p. 16, quoting Joel Slemrod and Jon Bakija and others.

[533] See *e.g.* DAGAN, Tsilly, ref. n. 531, p. 16. ; WELLS, Bret and Cym LOWELL. Tax Base Erosion and Homeless Income: Collection at Source. *Tax Law Review*. 2012, 65(3), p. 535.

[534] Kaplow writes "*were it not for differences among individuals that give rise to distributive concerns, revenue would optimally be raised instead through uniform lump-sum taxation, without causing any distortion*". KAPLOW, Louis, ref. n. 531, p. 21. For the discussion of the problem of heterogeneity of individual utility functions see *e.g.* BOADWAY, Robin, ref. n. 134, p. 30-34. For the implications of the second-best problem to tax law and economics, see RASKOLNIKOV, Alex. Accepting the Limits of Tax Law and Economics. *Cornell Law Review*. 2013, 98(3), p. 540-544. Available at: https://scholarship.law.cornell.edu/clr/vol98/iss3/1.

[535] DAGAN, Tsilly, ref. n. 531, p. 50. Both terms are ambivalent. The term benefits is not that common in current discussion and usually *value creation* serve instead of it. The term fairness is outright problematic because "*Fairness, ultimately, is a philosophical notion*" and "*Philosophers have been unable to agree on its meaning*". Chapter 1: Fairness.

efficiency on the international level[537] and international tax policy has been assessed accordingly.[538] Similarly, as in the closed economy model, tax policymakers dealing with international taxation want to achieve economic efficiency and maximize the global benefit[539] through specific tax neutrality. Economists recognize in relation to international taxation more forms of neutrality, *i.e.* capital export neutrality (CEN), capital import neutrality (CIN), capital ownership neutrality (CON), national neutrality (NN), and market neutrality (MN).[540] Capital export neutrality deals with investments and exists when "*residents of any given nation* (...) *face the same tax burden no matter where they choose to invest*".[541] Capital import neutrality deals with savings[542] and the "*taxation in the host country*"[543] and exists when "*the total tax imposed on investment returns in a given country remains constant irrespective of the investor's country of residence*".[544] Desain and Hines "*argue that the ownership of assets must be the focus in determining the efficiency results of taxes, as opposed to the location of investments (as in CEN) or how taxes affect savings (as in CIN)*".[545] Thus tax systems should not distort capital ownership and CON arises when "*it is impossible to increase output by trading capital ownership among investors*".[546] National neutrality "*sets national, and not the global, prosperity as its target*"[547] stating that "*a national government cannot be indifferent regarding which country gets to collect taxes on a given income, since tax revenues collected by the home country increase national welfare, whereas foreign taxes do not. Thus* (…) *investors should be encouraged to invest abroad only if both*

HOLMES, Kevin. *The Concept of Income: A Multi-Disciplinary Analysis.* Amsterdam: IBFD, 2001, [online]. ISBN 90-7607-8378. Nonetheless, the EU has been using the term fairness often in relationship to taxation in the EU. See *e.g.* PIRLOT, Alice. The Vagueness of Tax Fairness: A Discursive Analysis of the Commission's 'Fair Tax Agenda'. *Intertax*. 2020, 48(4), p. 402-415.

536 RICHMAN (MUSGRAVE), Peggy B. *Taxation of foreign investment income: an economic analysis*. Baltimore: The Johns Hopkins Press, 1963. B0037F1ACC.

537 The US substituted the concept of economic-allegiance rights-based allocation of taxing privileges among states proposed by the League of Nations by the concept of neutrality,. "*Gone was the old emphasis on benefits and fairness; instead, the argument was henceforward based on the economic concept of efficiency, which in the international context translated into neutrality (and in particular, capital export neutrality)*". See AVI-YONAH, Reuven S., ref. n. 509, p. 324.

538 WEISBACH, David A. The Use of Neutralities in International Tax Policy. *Coase-Sandor Institute for Law & Economics*. 2014, 2014 (Research Paper 697), p. 1.

539 HORST, Thomas. A Note on the Optimal Taxation of International Investment Income. *The Quarterly Journal of Economics*. Oxford University Press, 1980, 94(4), 793.

540 Richman proposed CIN and CEN, Feldstein and Hartman argued in favor of national neutrality, Desai and Hines proposed capital ownership neutrality and Devereux market neutrality. WEISBACH, David A., ref. n. 537, p. 1-2. See also FELDSTEIN, Martin S. and David G. HARTMAN. The Optimal Taxation of Foreign Source Investment Income. *QUARTERLY JOURNAL OF ECONOMICS*. John Wiley, 1979 (2004), NBER Working Paper Series (Working Paper w0193), p. 613-629. Available at: https://ssrn.com/abstract=260384. ; DESAI, Mihir A. and James R. HINES. Old Rules and New Realities: Corporate Tax Policy in a Global Setting. *National Tax Journal.* 2004, 57(4), p. 937-960. DOI: dx.doi.org/10.17310/ntj.2004.4.09. ; DEVEREUX, Michael P. Taxation of outbound direct investment: economic principles and tax policy considerations. *Oxford Review of Economic Policy.* Oxford University Press, 2008, 24(4), p. 698-719.

541 WEISBACH, David A., ref. n. 537, p. 3

542 WEISBACH, David A., ref. n. 537, p. 3.

543 DAGAN, Tsilly, ref. n. 531, p. 55.

544 DAGAN, Tsilly, ref. n. 531, p. 55.

545 DAGAN, Tsilly, ref. n. 531, p. 56.

546 DAGAN, Tsilly, ref. n. 531, p. 56-57.

547 DAGAN, Tsilly, ref. n. 531, p. 56.

the investor and the residence country's fisc benefit from the investment".[548] Market neutrality that deals with "*the nature of the competition between firms*" and "*holds if all potential competitors in a single market face the same effective tax rate*".[549]

Tax policymakers can consider these types of partial neutrality from a national point of view (the goal is to maximize the social welfare function of one country or particular region) or from a global point of view (the goal is to maximize the social welfare function of all countries which is by no means troublesome).[550] Unfortunately, neutralities described above are difficult to achieve in practice and can be exclusive.[551]

Dagan argues that since the system of international taxation is rather competitive, despite many initiatives for cooperation, it does not have to make sense for a national tax policymaker to base her decision about international tax policy on maximizing the global social welfare function but more on maximizing the national social welfare function.[552] To me, this argument makes sense because a rational tax policymaker should profit the most from maximizing the domestic social welfare function. Also, if the policymaker wants to be elected again, it does not help her to maximize the *global* social welfare function if there is no mechanism for how her country could benefit from it and increase the *domestic* social welfare function. This hurdle might be overcome to some extent by adopting formulary apportionment proposals, *e.g.* the EU CCCTB proposal,[553] the OECD formulary apportionment proposal,[554] and the UN proposal,[555] because these proposals allow allocation of tax

[548] DAGAN, Tsilly, ref. n. 531, p. 56. See also a description in WEISBACH, David A., ref. n. 537, p. 3-4.

[549] DEVEREUX, Michael P. and Simon LORETZ. Evaluating Neutrality Properties of Corporate Tax Reforms. *Centre for Business Taxation Working Paper.* Oxford, 2010, 10(07), 1. Available at: http://eureka.sbs.ox.ac.uk/id/eprint/3248.

[550] SCHÖN, Wolfgang. International Tax Coordination for a Second-Best World (Part I). *World Tax Journal.* 2009, 1(1), p. 71. For a general discussion on the social welfare function see *e.g.* KAPLOW, Louis, ref. n. 531, p. 41-52, 370-390.

[551] See *e.g.* DAGAN, Tsilly, ref. n. 531, p. 57-60. ; WEISBACH, David A., ref. n. 537, p. 5-12. ; HORST, Thomas, ref. n. 539, p. 793-798.

[552] DAGAN, Tsilly, ref. n. 531, p. 50-53.

[553] See ref. n. 243.

[554] "*Pillar 1 calls for revising profit allocation and nexus rules, while pillar 2 would introduce minimum corporate taxation*". JOHNSTON, Stephanie Soong and Ryan FINLEY. OECD Pillar 2 Draft Further Maps Out GLOBE Minimum Tax Proposal. Tax Notes International. 2020, 2020(August 24, 2020), p. 1087. For a summary of the OECD 2019 "*unified approach*" proposal see *e.g.* FINLEY, Ryan and Stephanie Soong JOHNSTON. TAX ANALYSTS. OECD Unified Approach Proposes Sharp Break With Current System. TAX ANALYSTS. *Tax Notes: Tax Notes Today International* [online]. Virginia, US: Tax Analysts, 2020 [cit. 2020-08-17]. Available at: https://www.taxnotes.com/tax-notes-today-international/base-erosion-and-profit-shifting-beps/oecd-unified-approach-proposes-sharp-break-current-system/2019/10/10/2b0t1. A blueprint bringing more details to the Pillar 1 should be ready by October 2020. JOHNSTON, Stephanie Soong. OECD Aims to Have Global Tax Deal Blueprints Ready in October. *Tax Notes* [online]. Virginia, US: Tax Analysts, 2020, July 14, 2020 [cit. 2020-08-17]. Available at: https://www.taxnotes.com/tax-notes-today-international/digital-economy/oecd-aims-have-global-tax-deal-blueprints-ready-october/2020/07/14/2cq87. For a summary of the pre-publishing version of the Pillar 1 blueprint see FINLEY, Ryan and Stephanie Soong JOHNSTON. New Detail on OECD's Pillar 1 Proposal Emerges in Draft Report. *Tax Notes* [online]. Virginia, US: Tax Analysts, 2020, August 6, 2020 [cit. 2020-08-17]. Available at: https://www.taxnotes.com/tax-notes-today-international/digital-economy/new-detail-oecds-pillar-1-proposal-emerges-draft-report/2020/08/06/2ct2k.

revenue.[556] Until the international tax system is fully centralized, Dagan recommends individual countries to promote their national interests (taxing strategically), unless there is a specific mechanism that allows countries to benefit from promoting international tax neutrality by their measures dealing with double taxation.[557] To conclude, there is no commonly accepted and widely practically applicable normative international income tax theory which means that we still cannot make a definitive normative economic statement on what is right.[558]

Nonetheless, as I described in Chapter 2, some scholars point out that the 1923 report and following work and model tax conventions created a system of more than 1500,[559] 2000,[560] 3000,[561] or, perhaps, 4000[562] bilateral tax treaties. These treaties build on model tax conventions[563] following the League of Nations double tax convention drafts[564] with the OECD Model Tax Convention[565] being the most influential in regard to the drafting language[566] and based on a few underlying principles.[567] Since double taxation was the main reason for concluding tax treaties in the 19th century and for the most part of the 20th century,[568] some authors argue that one of these principles is the single tax principle. This principle states that every item of income should be taxed once.[569] but not more or less than once[570] and at the tax rate determined by the benefits principle,[571] *i.e.* "*the*

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[555] The UN "*is trying to introduce a small portion of formulary apportionment into the global system. The proposal would give source countries the right to tax cross-border payments for automated digital services via a withholding tax on gross income or an apportionment formula on net income*". SARFO, Nana Ama. Why the United Nations Digital Tax Proposal Deserves More Attention. Tax Notes International. 2020, 2020(August 24, 2020), 995. See also *ibid*, p. 995-999, for the discussion of the proposal to amend the UN DTC Model.

[556] Notwithstanding that some authors dispute the existence of such regime. See ref. n. 225.

[557] DAGAN, Tsilly, ref. n. 531, p. 60-71.

[558] See *e.g.* SCHÖN, Wolfgang, ref. n. 550, p. 84.

[559] THURONYI, Victor. In Defense of International Tax Cooperation and a Multilateral Tax Treaty. *Tax Notes International*. 2001, 2001(March 12, 2001), p. 1291.

[560] KYSAR, Rebecca M. Unraveling the Tax Treaty. *Minnesota Law Review*. 2020, 104(4), p. 1756. Available at: https://minnesotalawreview.org/wp-content/uploads/2020/04/Kysar_Final.pdf.

[561] See AVI-YONAH, Reuven S., ref. n. 95, p. 3.

[562] Ash and Omri state that they used for the purposes of their research a database containing 4,052 bilateral treaties. ASH, Elliott and Marian Y., OMRI, ref. n. 208, p. 3.

[563] See *e.g.* ASH, Elliott and Marian Y., OMRI, ref. n. 208, p. 3. ; AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 197, p. 156-158

[564] See *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 311, 315-316. ; OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 53-56.

[565] The UN Model Tax Convention is however very similar in its wording. AVI-YONAH, Reuven S., ref. n. 115, p. 5.

[566] ASH, Elliott and Marian Y., OMRI, ref. n. 208, p. 4. See also *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 307.

[567] In particular the single tax principle and the benefits principle. See *e.g.* AVI-YONAH, Reuven S., ref. n. 115, p. 8-13.

[568] As I have shown above, the League of Nation's experts considered also the tax evasion problem.

[569] "*The report takes as a given that a person's entire "faculty" should be taxed by one state*". DAGAN, Tsilly, ref. n. 531, p. 45. Also Avi-Yonah quoting Thomas S. Adams writes that "*Income from cross-border transactions should be subject to tax once*". AVI-YONAH, Reuven S. International Taxation of Electronic Commerce. *Tax Law Review*. 1997, 52(3), p. 517.

[570] Avi-Yonah writes "*neither more nor less than once*". AVI-YONAH, Reuven S., ref. n. 569, p. 517.

[571] The benefits principle originally states that "*active (business) income should be taxed primarily at source while passive (investment) income should be taxed primarily on a residence basis*". AVI-YONAH, Reuven S., ref. n. 95, p. 4. However, Avi-Yonah points out that the "*reasoning behind this compromise is now obsolete; nevertheless, that is the principle that underlies all the tax treaties*". Avi-Yonah and Xu have recently argued that the BEPS Project has shown that countries should tax active income primarily on a residence basis while passive (investment) income should be taxed primarily at source. See

rate of tax for purposes of the single tax principle is generally the source rate for active business income and the residence rate for passive (investment) income".[572] The argument behind the single tax principle is that countries have based their international tax policy on this principle by concluding double tax treaties in accordance with the League of Nations Committee of Technical Experts first model treaty from 1927 and following model treaties which represent the first bite in the apple rule[573] as well as the benefits principle because it "*puts the onus of preventing double taxation on the residence jurisdiction and shifts the right to tax passive income from the source to the residence country*".[574] Avi-Yonah argues that the single tax principle manifests itself in the adoption of the foreign tax credit by the US in 1918 and then more clearly in the US Model Tax Convention from 1981 which included the broad limitation on benefits provision.[575] Moreover, in 2016, the US published a new version of the US Model Tax Convention containing several anti-tax avoidance rules, *e.g.* treaty exempt PEs, expanded LOB, anti-inversion rules, and *special tax regimes* definition.[576] The new version of the US Model Tax Convention obviously tries to further protect the US corporate tax base which seems to be in line with the single tax principle.[577]

Besides the discussion about double tax treaties and international law in general, Avi-Yonah argues further that domestic tax law rules of major economies also embody the single tax principle.[578] Examples of these domestic tax law measures are the foreign tax credit[579], anti-deferral

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AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 12, p. 189, 237. That would mean that the active income should be taxed at the rate of the residence country whereas the passive income should be taxed at the rate of the source country.

[572] AVI-YONAH, Reuven S., ref. n. 115, p. 9.

[573] The first bite in the apple rule recognizes that between residence and source the rights of the source country must prevail because, since the income arises within the source country, the residence country cannot prevent the source country from taxing that income. AVI-YONAH, Reuven S., ref. n. 95, p. 4.

[574] AVI-YONAH, Reuven S., ref. n. 95, p. 5.

[575] AVI-YONAH, Reuven S. Who Invented the Single Tax Principle?: An Essay on the History of US Treaty Policy. *New York Law School Law Review*. 2015, 59(2), p. 306-314.

[576] AVI-YONAH, Reuven S. Full circle? The Single Tax Principle, BEPS, and the New US Model. *Global Taxation*. 2016, 2016(1), p. 17-20. Available at: https://repository.law.umich.edu/articles/1820.

[577] AVI-YONAH, Reuven S., ref. n. 576, p. 20.

[578] See *e.g.* AVI-YONAH, Reuven S., ref. n. 115, p. 3-4. ; AVI-YONAH, Reuven S., ref. n. 95, p. 5.

[579] The foreign tax credit in general allows achieving taxation in situation where the source country does not tax income at all or the taxation is lower than taxation in the residence state. Parada in general argues that the credit method as well as the exemption method are not reliable methods to ensure single taxation. PARADA, Leopoldo, ref. n. 8, p. 25-31. I agree with Parada that, in general, both of these methods are not effective in ensuring single taxation because (i) the exemption method can leave some income untaxed if the source country effectively does not tax income and (ii) it is possible to achieve non-taxation outcome under the credit method, for example, by using foreign tax credit generator. But, the original aim of the exemption method was to alleviate the double tax problem. Nevertheless, tax policymakers have introduced several methods how to overcome the double non-taxation issue which shows that at least in some circumstances the double non-taxation is an unwanted outcome. However, the truth is that to achieve pure single taxation, the ideal tax policymaker would have to go through every possible double non-taxation scenario and then enact a rule against scenarios she considers unwanted, *e.g.* by using subject-to-tax clause, switch-over-clause, or CFC and similar rules.

rules (like FIF and CFC rules)[580], anti-hybrid mismatches rules, GILTI[581], BEAT[582], FATCA and MAATM[583], DAC[584], and other initiatives.[585] As regards the adoption of the ATAD and dealing with hybrid mismatches, the Commission issued a document accompanying the ATAD stating that the purpose of the ATAD is ensuring that "*an income cannot go untaxed (or taxed at very low level)*".[586]

In addition, the discussion has not been limited to the US international tax treaty policy but some authors also argue that even the influential OECD Model Tax Convention contains provisions representing the single tax principle.[587] But this argument is controversial, too.[588] Nonetheless, the recent development on the international level speaks in favor of single taxation. The interpretation of the BEPS Project is ambiguous because some argue that the BEPS Project promotes the single tax principle in some areas of international taxation[589] – the *formal* single tax principle in relation to hybrid mismatch arrangements[590] – whereas others argue that the BEPS Project actually leads to the rejection of the single tax principle.[591] Recent changes to the OECD DTC Model, in particular its preamble,[592] and the MLI initiative also aims to prevent some forms of tax avoidance and arguable

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580 Because "*these rules attempt to tax on a residence basis income that is unlikely to be taxed at source because it is mobile*." AVI-YONAH, Reuven S., ref. n. 95, p. 5. Moreover, the existence of these rules weakens an argument that using the credit method does not prove that the single tax principle exists. On the contrary, the exporting economies use CFC rules often to counteract exemption of income if the exemption method creates non-taxation of an income of a tax resident that the exporting economy wants to tax.

581 Avi-Yonah summarizes GILTI as "*a new category of Subpart F income that imposes current tax at 10.5 percent (half the US domestic corporate rate of 21 percent) on income of CFCs that exceeds a 10 percent deemed return on their basis in tangible assets*". AVI-YONAH, Reuven S., ref. n. 95, p. 45. See also on GILTI *e.g.* POSTLEWAITE, Philip F., Genevieve A. TOKIC, Jeffrey T. SHEFFIELD and Mitchell B. WEISS, ref. n. 99, p. 268-272. ; HERZFELD, Mindy, ref. n. 99, p. 505-510.

582 The BEAT "*is designed to limit the ability of domestic corporations to reduce their United States tax liability by making certain types of deductible payments to related foreign persons*". POSTLEWAITE, Philip F., Genevieve A. TOKIC, Jeffrey T. SHEFFIELD and Mitchell B. WEISS, ref. n. 99, p. 182. See also on BEAT *e.g.* HERZFELD, Mindy, ref. n. 99, p. 510-513. ; AVI-YONAH, Reuven S., ref. n. 95, p. 28-29.

583 Both leading to automatic exchange of information about financial accounts of taxpayers. See *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 120-121.

584 Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, as amended.

585 Avi-Yonah also acknowledges that some domestic rules are inconsistent with the single tax principle, *e.g.* participation exemption, but adds that even these rules contain provisions that protecting tax base and thus trying to achieve single taxation. AVI-YONAH, Reuven S., ref. n. 95, p. 5.

586 COMMISSION STAFF WORKING DOCUMENT Accompanying the document 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 SWD/2016/06 final.

587 DE LILLO, Francesco. In Search of Single Taxation. WHEELER, Joanna. *Single Taxation?*. Amsterdam: IBFD, 2018, p. 8-9. ISBN 978-90-8722-491-2.

588 DE LILLO, Francesco, ref. n. 587, p. 10-14.

589 For example, Avi-Yonah writes that "*the US, the OECD and the G20 clearly have adopted the single tax principle as their goal*". AVI-YONAH, Reuven S., ref. n. 576, p. 20. See also *ibid*, p. 15-17, on a brief discussion of the BEPS Project, its scope, and the relation to the single tax principle concluding that even though the BEPS will not eliminate non-taxation situations, the commitment is obvious.

590 See Chapter 5.

591 See a discussion in GARCÍA, Elizabeth Gil, ref. n. 85, p. 337-339.

592 The Preamble now includes wording stipulating that states intend to conclude a double tax treaty "*for the elimination of double taxation* (…) *without creating opportunities for non-taxation or reduced taxation*". See OECD, ref. n. 66, p. 27.

fosters the single tax principle.[593] Moreover, the OECD has come up with a solution to the taxation of digital commerce issue that aims to promote *substantial* single taxation by adopting a worldwide minimum income tax.[594] Such accomplishment would certainly be groundbreaking and foster single taxation. Considering measures trying to prevent double taxation and non-taxation in public international law and domestic law, Avi-Yonah concludes that the single tax principle "*is embodied both in the tax treaty network and in the domestic law of the major trading nations*".[595]

However, as I also described in Chapter 2, other prominent authors argue against the existence of the international tax regime.[596] In fact, some scholars argue that multiple taxation is not inherently wrong. For example, Dagan suggests a view using a continuum of taxation where on one end of the continuum, both countries raise no taxation;[597] on the other end of the continuum, both countries raise their taxes on a particular income (transaction). On the one hand, this opinion is consistent with current agnosticism regarding an ideal normative model of international taxation. On the other hand, this perception may clash with the interests of tax policymakers representing people who want to achieve some form of taxation which they perceive right (enough) from their tax policy perspective. To add more complexity, tax policymakers have to deal with the reality of international taxation which includes tax competition and tax cooperation.[598] For instance, Dagan argues that for developing countries, it may be in their national interest to prefer source taxation, but developed countries can push them to prefer cooperation even though it is not in their interest.[599]

In addition, Graetz and O'Hear disagree with the foreign tax credit argument and point out that the foreign tax credit does not always ensure single taxation but only alleviates potential double taxation,[600] which relativizes the argument regarding a potential non-taxation. The argument concerning the limitation on benefits provision is also dubious because such provision does not deal with all instances of double non-taxation but prevents only some cases arising out of tax treaty shopping.[601]

This is a viable argument if the single tax principle should apply to all cross-border situations but it is possible that the single tax principle ought to apply only to certain situations or that it should be regarded as a tax policy goal to some extent. Thus, the argument leads to the question,

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593 Avi-Yonah and Xu argue that the MLI fosters the single tax principle especially by the principal purpose test which is part of the minimal standard of the MLI. See *e.g.* AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 197, p. 159.

594 See on the Pillar II *e.g.* DOURADO, Ana Paula. The Global Anti-Base Erosion Proposal (GloBE) in Pillar II. *Intertax*. 2020, 48(2), p. 152-156.

595 AVI-YONAH, Reuven S., ref. n. 115, p. 1-2.

596 See ref. n. 225.

597 DAGAN, Tsilly, ref. n. 531, p. 45.

598 On this debate, see *e.g.* DAGAN, Tsilly, ref. n. 531, p. 1-245.

599 DAGAN, Tsilly, ref. n. 531, p. 110-119.

600 GRAETZ, Michael J. and Michael M. O'HEAR, ref. n. 527, p. 1022.

601 GARCÍA, Elizabeth Gil, ref. n. 85, p. 314.

what is actually the nature of the single tax principle? Is it a tax theory principle, a tax policy goal or a legal principle (rule)? And what is the extent of the single tax principle? Does it apply to all cross-border situations or only to some?

The discussion about the nature of the single tax principle is puzzling because it is not always obvious what is the context of the discussion and arguments involve referring to underlying theory as well as explicit and implicit tax policy, and legal provisions. Therefore, I would like to entangle this to some extent to move further the dissertation's argument. Some scholars have provided useful terms to aid such a discussion. This discussion also shows some weak spots of the single tax principle and its application.

Schoueri and Galdiano discuss the practical implications of the single tax principle and analyze whether a country should pursue the single tax goal or not as part of its tax policy.[602] To pursue their argument, they further divide the single tax principle into *formal* single taxation and *substantial* single taxation.[603] Formal single taxation encompasses situations where the cross-border income should not be subject to more than one levy.[604] Substantial single taxation deals with a question of how much should countries tax the cross-border income, regardless of how many times countries tax the income. Similarly to Shaviro[605] and De Lillo[606], they conclude that *formal* single taxation is not a practically useful principle.[607] Schoueri and Galdiano acknowledge that the benefits principle should determine the tax rate of *substantial* single taxation but argue that the benefits principle does not hold firm ground.[608]

Shaviro describes double taxation and double non-taxation as an *upside* and *downside departure* from the single tax principle.[609] On historical grounds, the upside departure of the single tax principle (multiple taxation) was important and dominating the debate which was trying to prevent double taxation which could lead to harsh taxation after the First World War.[610] The downside departure has become more important recently.[611]

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602 GALDIANO, Guilgerme and Luís Eduardo SCHOUERI. Single Taxation as a Policy Goal: Controversial Meaning, Lack of Justification and Unfeasibility. WHEELER, Joanna. *Single Taxation?*. Amsterdam: IBFD, 2018, p. 83-106. ISBN 978-90-8722-491-2.

603 GALDIANO, Guilgerme and Luís Eduardo SCHOUERI, ref. n. 602, p. 83-88.

604 GALDIANO, Guilgerme and Luís Eduardo SCHOUERI, ref. n. 602, p. 84-85.

605 SHAVIRO, Daniel. *Fixing U.S. International Taxation*. Oxford: Oxford University Press, 2014, p. 6-7. ISBN 9780199359752.

606 DE LILLO, Francesco, ref. n. 587, p. 50-54.

607 "*A formal approach is irrelevant, since the number of levies does not mean anything*". GALDIANO, Guilgerme and Luís Eduardo SCHOUERI, ref. n. 602, p. 105-106 (approximately, I used the e-book format). See *ibid*, p. 83-84, for the discussion why formal approach brings problems. Since they mention situations when single taxation is apparently not the goal, it is obvious that the single tax principle is a principle but not a rule, if it exists.

608 GALDIANO, Guilgerme and Luís Eduardo SCHOUERI, ref. n. 602, p. 86-88.

609 SHAVIRO, Daniel. Two Faces of the Single Tax Principle. *Brooklyn Journal of International Law*. 2016, 41, p. 1294.

610 Quoting Dagan see *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 315.

611 GARCÍA, Elizabeth Gil, ref. n. 85, p. 315.

García made recently another addition to the discussion. She too posed the question: "*What is the nature of the single tax principle?*"[612] and persuasively argues that the single tax principle is neither legal custom[613] nor a legally binding principle under Article 38(1)(c) of the ICJ Statute[614] but some non-binding international tax regime exists.[615] In addition, Bentil lately argued that the international tax system is treaty-based only because domestic rules without *opinio juris* cannot create an international custom and this opinion is generally lacking.[616]

To conclude, neither tax policy nor tax theory show a resolute general approach toward double taxation and implementation of the single tax principle, although both parties have come up with substantial arguments supporting their position. However, since the discussion is inconclusive, I conclude that states and their tax policymakers are still free in their taxing decisions until proven otherwise, in particular by some legally binding rule.

The debate about the existence of the single tax principle has been raging on without any conclusive outcome since the first publication of Avi-Yonah's work. But is this indeterminate debate worth it? I think that the discussion is very important because the answer probably lies somewhere in between and never-ending discussion hopefully shifts the answer to the right spot. Therefore, the single tax principle emerges and disappears from tax policy arguments and legal documents from time to time.[617] I thus think that the perception of double taxation, double non-taxation, and the single tax principle is function encompassing (i) theoretical discussion, (ii) current tax policy discussion and proposals, and (iii) legal rules. And the overall discussion shows where we stand in these three areas right now, which is beneficial because we will not miss it if something changes. However, I consider it essential to properly distinguish the context of various claims. Theory can be indifferent whereas tax policy and tax law cannot. It is crucial to distinguish between tax theory assessment, tax policy claims and intents, and effective legal rule. Right now, the single tax principle is seemingly rising because current advance in international taxation initiatives has led to the unprecedented, but still partial, cooperation based on an assumption that in some circumstances single taxation should prevail over non-taxation.

Although countries are free to structure their tax policy, they must fulfill their legal duties. From the perspective of public international law, it is necessary to find any legal norm that would

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[612] GARCÍA, Elizabeth Gil, ref. n. 85, p. 313.
[613] GARCÍA, Elizabeth Gil, ref. n. 85, p. 313. See also *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 83.
[614] GARCÍA, Elizabeth Gil, ref. n. 85, p. 344.
[615] GARCÍA, Elizabeth Gil, ref. n. 85, p. 333.
[616] BENTIL, John. Situating the International Tax System within Public International Law. *Georgetown Journal of International Law*. 2018, 49(4), p. 1219-1270.
[617] See *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 315.

prohibit departure from single taxation. In terms of cross-border income taxation, such a rule would have to stem from a uniform system of rules in domestic law, either as a legal custom of legal principle or directly from public international law, *i.e.* legal custom or legal treaty. Since there is no worldwide minimum tax and domestic rules still allow non-taxation and double taxation, it does not seem probable that an overall rule exists in either form.[618] However, this can change in the future. In terms of cross-border income taxation, such rule would have to stem from domestic law in combination with *opinion juris* or public international law, *i.e.* other forms of international custom or international treaty (treaties). Customary public international law does not contain a rule that would generally give taxpayers the right to double taxation relief.[619] Treaty public international law can create such rights but only if it based on an agreement concluded by two or more countries.[620] Thus, in practice, countries that have tax jurisdiction over a particular cross-border income have to decide how much they are going to tax such income based on the tax policy they want to pursue and, from the legal point of view, their decision can limit only a constitutional rule, for example, that taxes should not be confiscatory or international treaty.[621]

Although the academic discussion on double taxation is inconclusive, states still have to somehow deal with double taxation reality. Hence, states use (i) allocation of taxing rights (tax treaties) and (ii) unilateral and bilateral methods to alleviate juridical and economic double taxation,.[622] The allocation of taxing rights between states represents the concept of economic-allegiance rights-based allocation of taxing rights as a way how to deal with more states taxing one income.[623] Other unilateral and bilateral methods represent the concept of neutrality which replaced the former approach to taxing cross-border income.[624]

The allocation of taxing rights uses provisions of tax treaties to divide the rights to tax a certain income amongst parties to the treaty. A double tax treaty contains provisions that characterize a particular item of income assign which state that has a right to tax such income and

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[618] If not, countries can use the basic argument from the Lotus case that what is not prohibited, is allowed. See PCIJ, September 7, 1927, Series A, No. 10, *S.S. Lotus (France v Turkey)*, par. 76.
[619] PARADA, Leopoldo, ref. n. 8, p. 16-17.
[620] GARCÍA, Elizabeth Gil, ref. n. 85, p. 346.
[621] See *e.g.* PARADA, Leopoldo, ref. n. 8, p. 16. The Constitutional Court of the Czech Republic considers tax constitutional if the tax does not violate equity and is not extremely disproportional, *i.e.* tax is not "*choking the taxpayer*". See *e.g.* The Constitutional Court of the Czech Republic, August 18, 2004, Pl.ÚS 7/03, part VIII, par. 18. ; The Constitutional Court of the Czech Republic, Pl.ÚS April 21, 2009, 29/08, par. 49. ; The Constitutional Court of the Czech Republic, July 10, 2014, Pl.ÚS 31/13, par. 42, 48.
[622] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 25-42, 48-49.
[623] See ref. n. 537.
[624] See ref. n. 537.

under what conditions.[625] This form of a double taxation relief mostly uses bilateral double juridical taxation relief as its complement because it often assigns taxing rights to both states.[626]

Methods of unilateral and bilateral double juridical taxation relief are (i) exemption method, (ii) credit method, (iii) tax sparing method, (iv) deduction method, and (v) reduced rate method.[627] Countries commonly use the exemption method, credit method, and deduction method.[628] These methods represent the types of neutrality in international taxation that I mentioned above. Exemption method allows investors to exclude income sourced in foreign countries from their tax liability in the country of their residence. The exemption method thus represents (i) the capital import neutrality because they try to achieve the same tax rate (irrespective of tax residence) of all investments in particular jurisdiction and (ii) capital ownership neutrality because "*the tax treatment of foreign investment income is the same for all investors and competition between potential buyers allocates assets to their most productive owners*"[629]. The credit method allows investors to credit taxes paid in a foreign country against taxes due in the country of investors" tax residence.[630] The credit method represents the capital export neutrality because it aims to achieve the same tax rate for domestic as well as foreign investments of tax resident investors.[631] A tax sparing is a specific subset of credit method because it allows crediting foreign taxes that actually were not paid.[632] The tax deduction method allows investors to deduct taxes they paid in a foreign country from taxes they must pay in their tax residence country. The tax deduction method represents the national neutrality because it aims to allow the tax residence country to fiscally benefit from investments in foreign countries of the country's tax residents.

When choosing between methods of double tax relief, the tax policymaker has to consider three factors, *i.e.* capital export neutrality, protection of its tax base, and the complexity of the method adopted.[633]

Methods of double economic taxation relief are less unified but include domestically at corporate level (i) dividend deduction or credit method, (ii) split-rate method, and (iii) dividend exemption system, whereas at a shareholder level tax laws contain (i) dividend credit, and (ii)

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[625] See *e.g.* Articles 6-22 of the OECD DTC Model.

[626] See *e.g.* Articles 6-22 of the OECD DTC Model in connection with its Article 23A and B.

[627] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 25-42. ; OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 96-105.

[628] OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 97, 110-130.

[629] DESAI, Mihir A. and James R. HINES. Evaluating International Tax Reform. *National Tax Journal*. 2003, 56(3), p. 494.

[630] OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 101-103.

[631] DAGAN, Tsilly, ref. n. 531, p. 55. ; OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 101-103.

[632] See on tax sparing briefly *e.g.* OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 181.

[633] OATS, Lynne, Angharad MILLER and Emer MULLIGAN, ref. n. 79, p. 101-105.

dividend relief.[634] States alleviate the problem of double economic taxation in cross-border situations by using (i) participation exemption, and (ii) indirect credit.[635]

To sum up, international juridical double taxation is an outcome of overlapping taxing rules based on residence taxation, source taxation, or their combination. Tax theory currently is indecisive in assessing the double taxation outcome as either right or wrong. In tax policy practice, however, states have often perceived double taxation as unwanted. In such a case, states prevent double taxation by unilateral, bilateral or multilateral means. Even though countries use these means widely, so far it cannot be inferred that there is a right to double taxation relief that would be part of customary public international law, but such a right can stem from international tax treaties or domestic law.[636] The discussion has also shown that the single tax principle is currently not part of international law in form of international custom but this may change in the future due to the US, EU, OECD and UN initiatives. However, the BEPS Action 2 is one of few actions where scholars mostly agree that its aim is to deal with non-taxation, *i.e.* the downward departure from the single tax principle.

4.3. Double Non-Taxation and Its Normative Assessment

Non-taxation is a situation when income is not taxed at all. This situation can appear in either domestic or cross-border situations. Domestic non-taxation does not create tax policy concerns because domestic tax policymaker has probably decided not to tax such income.[637] Otherwise, tax laws would subject such income to taxation because tax policymakers can amend the law. However, double non-taxation is a specific form of non-taxation in cross-border situations bringing more complexity because these situations involve the interaction of rules of two or more countries.

The definition of double non-taxation is comingled with its normative assessment. Parada thoroughly analyzed the debate on double non-taxation and identifies four perspectives on what is double non-taxation and what its normative assessment is.[638] These perspectives are (i) double non-taxation as the reverse side of double taxation, (ii) double non-taxation, under-taxation, and stateless

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[634] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 37-39.

[635] See *e.g.* OSTASZEWSKA, Ola and Belema OBUOFORIBO, ref. n. 67, p. 40-42.

[636] Recently vis-a-vis the international level see *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 320-321.

[637] This domestic exclusion from taxation is either implicit or explicit. Implicit form is when the tax law does not explicitly mention item of income but it is not in a scope of tax law anyway. Example of this are flows of money which at least in theory do not constitute income, *e.g.* taxpayer subjected to accrual income taxation receives borrowed money. Explicit exclusion from taxation has various forms. For instance, the tax law explicitly stipulates that certain item of income is exempted from taxation, *e.g.* receiving a payment of pension.

[638] PARADA, Leopoldo, ref. n. 8, p. 15-106.

income, (iii) double non-taxation as an intended or unintended outcome, and (iv) double non-taxation as per se undesirable outcome.[639]

The first approach to double non-taxation perceives double non-taxation as the reverse side of double economic or judicial taxation.[640] Regarding double taxation, two countries subject one income to taxation. As regards (double) non-taxation, no country subjects an item of income to taxation in such a scenario.[641] This outcome appears either because of "*the disparities in domestic laws, the application of a tax treaty provision or the simple decision of a State not to exercise its taxing rights.*"[642] The normative assessment of double non-taxation is in the first approach the same as for the double taxation, *i.e.* the assessment is inconclusive.

The second approach to double non-taxation views double non-taxation as ¨the absence of taxation as well as under-taxation[643] and/or so-called *stateless income*[644].[645] This approach is thus broader than no taxation at all as the first approach suggests. Parada points out that there should be a distinction between pure double non-taxation and under-taxation.[646] I agree for two reasons. Firstly, the discussion about pure double non-taxation deals with a question of whether something should be taxed or not, whereas the discussion about under-taxation deals with a question if countries should tax something and how much they should tax it. Secondly, I think this distinction has important consequences for the interpretation and application of legal rules which countries use to deal with hybrid mismatch arrangements and their outcomes. Depending on the underlying tax policy aim, these rules can have two possible aims. One aim is to subject cross-border income to single taxation regardless of the tax rate, *i.e. formal* single taxation. The second aim is to subject cross-border income to (single) taxation achieving at least a certain effective tax rate, *i.e. substantial* (single) taxation. Parada includes into the second approach also the notion of *stateless income* which basically denotes shifting profits from high-tax jurisdictions to lower-tax jurisdictions using complex tax planning techniques.[647]

The third approach considers double non-taxation from the perspective of intentions of states, *i.e.* tries to answer a question whether a particular double non-taxation outcome is an

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639 PARADA, Leopoldo, ref. n. 8, p. 15.
640 PARADA, Leopoldo, ref. n. 8, p. 15-17.
641 See examples of these situations in Chapter 3.
642 PARADA, Leopoldo, ref. n. 8, p. 17.
643 Including a long-term deferral because it is economically equivalent to double non-taxation.
644 Main proponent of the term stateless income is Kleinbard. See KLEINBARD, Edward D. The Lessons of Stateless Income. *Tax Law Review*. 2011, 65(1), p. 99-171. ; KLEINBARD, Edward D. Stateless Income. Florida Tax Review. 2011, 11(9), p. 700-774.
645 PARADA, Leopoldo, ref. n. 8, p. 17-19. Some authors use a term *homeless income*. See *e.g.* WELLS, Bret and Cym H. LOWELL, ref. n. 11, p. 38. ; WELLS, Bret and Cym LOWELL, ref. n. 533, p. 535-615.
646 PARADA, Leopoldo, ref. n. 8, p. 17-19.
647 PARADA, Leopoldo, ref. n. 8, p. 18-19.

intended (voluntary) or unintended (involuntary) outcome.[648] Intended double non-taxation is a situation where "*every country that has the right to impose the relevant tax on a particular subject matter has agreed that no tax should be imposed upon that subject matter, or the countries have agreed on which of them should exercise the jurisdiction to tax a particular subject matter, but the relevant country has not exercised that jurisdiction*".[649] Unintended double non-taxation is a situation where "*more than one country could impose the relevant tax on a particular subject matter but none of them has done so because each of them is of the view that another has the (or a superior) jurisdiction to impose the tax*"[650] Thus, the intention refers to the intention of countries. This is problematic because intentionality is a *subjective* element that is hard to prove. Parada raises two objections to the approach construing an intent of the state to normatively assess the double non-taxation situation.[651] The first objection is that it opens doors to various questions about where to look for the intention of a state. For instance, should one look only into explicit wording in legally binding documents, *e.g.* domestic laws or tax treaties? Or should one also consider other documents that are not legally binding but lawyers use them to find an aim of a statute, *e.g.* explanatory memorandum, tax policymaker communications, treaty negotiation acts? And how to deal with the specifics of the law-making process?[652] Parada concludes that since it is difficult to identify a pure "*intention of the States*" in most cases and for "*the sake of clarity and legal certainty*", one should disregard the intentionality element for assessing double non-taxation situation unless the intention is explicit in domestic laws or tax treaties, *e.g.* in "*either subject-to-tax or switch-over-clause to prevent double non-taxation or tax sparing and matching credit clauses in a clear tolerance of the DNT outcome*".[653]

Lastly, the fourth approach states that the double non-taxation is assessed as the ultimately undesirable outcome in the single tax principle debate.[654] Again, from the legal perspective, the single

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[648] PARADA, Leopoldo, ref. n. 8, p. 19 and following.
[649] PARADA, Leopoldo, ref. n. 8, p. 19.
[650] PARADA, Leopoldo, ref. n. 8, p. 19.
[651] PARADA, Leopoldo, ref. n. 8, p. 19-21.
[652] For instance, in the Czech Republic, the Ministry of Finance´s public servants draft most of tax bills. Drafts of these bills go through two procedures where they receive feedback. However, only certain institutions and interest groups are part of this process. Then, the Government of the Czech Republic gives an assent to the bill and sponsors the bill in the Parliament. The bill then goes through three rounds of reading where either *výbor* or individual MPs can submit a substantial amendment to the original bill. Lastly, the bill goes to the Senate and then President has to either sign the bill or veto it. During the whole process, various interest groups can manipulate the process into their favor. This applies especially during the first round of feedback, and second reading in the *Poslanecká sněmovna*. Besides that, tax laws in the Czech Republic are crystal clear in comparison to the American tax laws but generally Czech tax laws are complex which means that the bill receives feedback to only few provisions. So the question is, who and how creates the intent of the state? Or whose intent is it anyway? From the formal perspective, it is certainly the Parliament´s. But in fact, it is a mishmash of intent of legal drafter, interest groups, Ministers of Government, MPs, Senators, perhaps even Presidents, and of others involved, e.g. lobbyists. Also the lobbying has not yet been complexly regulated in the Czech Republic. Similar situation which applies to domestic tax laws also applies to Czech double tax treaties because the few public servants of the Ministry of Finance negotiate these treaties.
[653] PARADA, Leopoldo, ref. n. 8, p. 21.
[654] PARADA, Leopoldo, ref. n. 8, p. 22.

tax principle is not a general legally binding rule.[655] The single tax principle can appear as a legal rule in some instances but it is mostly a tax policy principle which countries can but does not have to follow.[656] When countries follow the single tax (policy) principle, they have to create a legally binding rule that allows taxpayers to recognize how to behave so they achieve sufficient legal certainty. Therefore, it is crucial to make a clear distinction between the single tax (policy) principle as a tax policy principle, where the goal is either *formal* single taxation or *substantial* single taxation in some or all cross-border situations, and a single taxation legal rule, *i.e.* a legal rule enforcing single taxation in certain situations, which may is a representation of the single tax (policy) principle.

To sum up, the literature on double non-taxation is inconclusive regarding its normative assessment. However, even though the academic debate on normative assessments of double non-taxation continues, tax policymakers may assess some situations of double non-taxation as undesired from their perspective for various reason, *e.g.* because tax arbitrage exploiting double non-taxation situations to lower taxpayer´s overall tax duty, and subsequently enact rules preventing such outcomes.

4.4. Alleviation of Double Non-Taxation Stemming from Hybrid Mismatch Aarrangements: Single Taxation as a Partial Tax Policy Goal?

The above discussion about the normative assessment of double taxation and double non-taxation does not lead to a conclusive statement that double taxation or double non-taxation are always undesirable outcomes. Nevertheless, tax policymakers have made statements that they consider certain cases of tax arbitrage undesirable and they want to enforce taxation in some situations. These situations include hybrid mismatch arrangements as expressed by the OECD/G20 in the BEPS Project Action 2 and the EU in the ATAD. Thus, the question is what is the underlying policy and the outcome of the application of the solution proposed by the OECD and the EU?

I argue in the following chapter that the solution the OECD and the EU suggest for outcomes of hybrid mismatch arrangements leads to *formal* single taxation which shows that their current tax policy does not foster *substantial* single taxation in regard to these arrangements.

4.5. Summary and Conclusion

From the tax theory perspective, the literature on double taxation and (double) non-taxation situations divides into the assessment of whether multiple taxation and (double) non-taxation are always undesirable or not. The discussion shows that there is currently no centralized cooperative

[655] LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 83.

[656] This does not apply to EU Member States in regard to hybrid mismatche because they must implement the ATAD. See Chapter 5.

international tax regime but the international tax arena includes initiatives leading to a certain degree of centralization and cooperation. Nevertheless, double taxation and double non-taxation are inevitable outcomes of the current decentralization of the international tax arena because states promote their own interests. States use various strategies to unilaterally, bilaterally, or multilaterally deal with double taxation and double non-taxation. These strategies might represent the single tax (policy) principle which is still a controversial concept that currently does not constitute a generally applicable legally binding rule as part of customary international law but can be enacted as a legal rule in particular cases.

Regardless of the theoretical debate, tax policymakers can have reasons to enforce single taxation in situations that they perceive undesired from their tax policy perspective. One set of these cases encompasses situations of hybrid mismatch arrangements that the OECD describes in its BEPS Project Action 2 and which lead to multiple taxation and non-taxation outcomes. Since it is currently impossible to claim what is the right thing to do, the answer rests on tax policymakers to make the decision. And G20, OECD, and EU tax policymakers have expressed their concern regarding the outcomes of hybrid mismatch arrangements.

5. The Taming of the Shrew: Linking Rules in BEPS Project Action 2 and the ATAD – A Perfect Solution?

5.1. Introduction

The subject of this chapter is an analysis of the OECD's linking rules that the OECD recommends as the principal solution to the non-taxation outcomes of hybrid mismatch arrangements and the EU uses as the principal solution. Firstly, I describe the OECD BEPS Action 2 linking rules in regard to hybrid entities, D/E HFIs, and hybrid transfers and analyze the underlying tax policy aim of these linking rules. Secondly, I describe the EU ATAD linking rules in regard to hybrid entities, D/E HFIs, and hybrid transfers and analyze their tax policy aim. Thirdly, I join the critique of other scholars explaining that linking rules are effective only in preventing pure non-taxation but come with many practical shortcomings and do not deal with low taxation. Lastly, I argue that the ATAD creates a new legal rule in the EU while dealing with hybrid mismatch arrangements, *i.e. formal* single taxation, and that the more countries adopt linking rules, the greater the probability that *formal* single taxation of hybrid mismatch arrangements will become part of international customary law.

The aim of this chapter is to argue that the underlying tax policy of linking rules is *formal* single taxation which brings new possibilities to tax planning and to show that linking rules are not a perfect solution to hybrid mismatches and tax policymakers as well as scholars should thus consider other solutions to hybrid mismatches.

5.2. Where Should Atlas Shrug It Off? The BEPS Action 2 Linking Rules

As I discussed in Chapter 1, international tax avoidance and tax evasion have attracted a lot of attention after the financial crisis in 2008 because politicians had to deal with news about rich MNEs and individuals moving their income to jurisdictions with tax havens. Politicians thus faced pressure toward upholding the social welfare state.[657] This pressure spurred many projects on various levels. One of the most influential actions in recent years is certainly the BEPS Project that deals among other topics also with outcomes of hybrid mismatches. The BEPS Project deals with hybrid mismatches mainly in Action 2 and concerns only a specific subset of hybrid mismatches that the BEPS Project calls *hybrid mismatch arrangements* (see Chapter 3).

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[657] For the discussion of the previous decline in the international tax regime and dealing with a question of whether a world tax organization should exist or not, see *e.g.* AVI-YONAH, Reuven S. Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State. *Harvard Law Review*. 2000, 113(7), p. 1573-1676. DOI: 10.2307/1342445. ISSN 0017811X. Available at: https://www.jstor.org/stable/1342445?origin=crossref. ; AVI-YONAH, Reuven S. *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State: A Twentieth Anniversary Retrospective*. Law & Economics Working Papers. 2019, 156. Available at: https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1270&context=law_econ_current.

The OECD has informed about hybrid mismatch arrangements in many reports but for the BEPS Project are crucial especially six reports published in the years 2010-2015. In 2010, the *Addressing Tax Risks Involving Bank Losses* report showed how tax planners can use hybrid mismatches to derive no taxation outcomes.[658] In 2011, the OECD report on *Corporate Loss Utilisation through Aggressive Tax Planning* showed broader possibilities of how taxpayers can deduct the same loss in more jurisdictions and how taxpayers can therefore achieve DD outcome.[659] Then, the OECD started analyzing other possible schemes that use hybrid mismatches to achieve lower or no taxation. This inquiry led to the report on *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* from 2012.[660] This report showed what hybrid mismatches are, what their elements and effects are, and what some examples of hybrid mismatches structures are.[661] The 2012 report deals with tax revenue as one of the tax policy issues and concludes that "*the collective tax base of countries is put at risk through the operation of hybrid mismatch arrangements even though it is often difficult to determine unequivocally which individual country has lost tax revenue under the arrangement.*"[662] The 2012 report also states that the hybrid mismatch arrangements have a negative impact on competition, efficiency, transparency, and fairness.[663] The report then discusses policy options for dealing with hybrid mismatch arrangements, *i.e.* (i) harmonization of domestic laws, (ii) general anti-avoidance rules, (iii) specific anti-avoidance rules, and (iv) rules specifically addressing hybrid mismatch arrangements.[664]

Firstly, the report states that the harmonization of domestic laws is only a theoretical solution and mentions it only for the sake of completeness.[665]As I argue in the next chapter, this approach to harmonization of domestic laws as the theoretical solutions is no longer true. Certainly, achieving such harmonization on the multilateral level is improbable; nevertheless, the CRS, the OECD BEPS Project, MLI project, and current initiatives dealing with digital taxation show that countries are willing to cooperate in the area of international taxation.[666] Also, countries can achieve some level of harmonization using unilateral means such as coordination rules.

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[658] OECD. *Addressing Tax Risks Involving Bank Losses*. Paris: OECD, 2010. ISBN 978-92-64-08868-9.

[659] OECD. *Corporate Loss Utilisation through Aggressive Tax Planning*. Paris: OECD, 2011. ISBN 9789264119215.

[660] OECD. *Hybrid Mismatch Arrangements: TAX POLICY AND COMPLIANCE ISSUES*. Paris: OECD, 2012. Available at: https://www.oecd.org/ctp/aggressive/HYBRIDS_ENG_Final_October2012.pdf.

[661] OECD, ref. n. 660, p. 7-10.

[662] OECD, ref. n. 20, p. 15.

[663] OECD, ref. n. 660, p. 11-12.

[664] OECD, ref. n. 660, p. 13-25.

[665] OECD, ref. n. 660, p. 13. Cooper agrees with this point on practical grounds. See COOPER, Graeme S., ref. n. 353, p. 345.

[666] Similarly see *e.g.* AVI-YONAH, Reuven S., ref. n. 576, p. 12-22. ; AVI-YONAH, Reuven S. and Haiyan XU, ref. n. 197, p. 155-216.

Secondly, the report considers a GAAR[667] as an effective tool in some cases of hybrid mismatch arrangements ("*in particular those with circular flows, contrivance or other artificial features*") but limited regarding the hybrid mismatch arrangements due to the GAAR's conditions and a requirement to show "*direct link between the transactions and the avoidance of that particular jurisdiction's tax*".[668] The report therefore does not consider the GAAR as a comprehensive solution toward hybrid mismatch arrangements.[669] The GAAR usually needs objective and subjective criteria to apply whereas linking rules are lacking the subjective condition. Therefore, as I wrote above, some scholars lack this I do not agree with this opinion because using subjective criterion to deal with hybrid mismatch arrangements and their outcomes (i) does not help to achieve the OECD tax policy aim (achieving single taxation somewhere) in cases where the country wants to subject income to taxation but hybrid mismatch arrangements is an outcome of a genuine transaction, (ii) proving a subjective element in the GAAR is a nightmare for any tax authority, and (iii) the GAAR does not help taxpayers and tax advisors to sleep any better because its possible application seems to be omnipresent in any transaction leading to lowering of tax duty.

Thirdly, the report considers a SAAR[670] as a solution to hybrid mismatch arrangements.[671] The report lists examples of SAARs mentioning for example the Dutch rule allowing denying "*the deduction of payments in cases where the same are not subject to a minimum level of taxation in the country of the recipient*".[672] The report does not explicitly state why these approaches are not comprehensive but only lists examples of SAARs in various countries.[673]

Lastly, the report describes that some countries have enacted rules that specifically address certain hybrid mismatch arrangements by linking the domestic tax treatment with the foreign tax treatments of an entity, instrument or transfer.[674] The report then shows examples of the rules

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[667] The discussion about the GAAR and its use is outside of the dissertation's scope. However, on the one hand, its greatest shortcomings are "*uncertainty for taxpayers*" and "*unfairness resulting from selective application*"; on the other hand, case law can lower the uncertainty and the GAAR can lead to simpler tax system design. All in all, the GAAR shifts ultimate power to judges but can also paradoxically limit their power depending on the wording of the GAAR. However, judges have such power commonly because of development of tax related doctrines such as substance over form, sham transactions *etc*. KREVER, Richard. General Report: GAARs. LANG, Michael. *GAARs - A Key Element of Tax Systems in the Post-BEPS World*. Amsterdam: IBFD, 2016, p. 1-2. ISBN 978-90-8722-358-8. See also on the advantages and disadvantages of statutory GAARs *e.g.* Statutory General Anti-Avoidance Rules – Advantages and Disadvantages. TOOMA, *Rachel Anne. Legislating Against Tax Avoidance*. Amsterdam: IBFD, 2008, [online]. ISBN 978-90-8722-034-1.

[668] OECD, ref. n. 660, p. 13.

[669] OECD, ref. n. 660, p. 13.

[670] Specific anti-avoidance rules protect some tax rules from their abuse or deal with some forms of tax avoidance that tax policymaker does not want to allow. SAAR's benefit is that it is tailored to needs of a particular rule and makes conditions and outcomes more specific than the GAAR. See *e.g.* KREVER, Richard, ref. n. 667, p. 1-2.

[671] OECD, ref. n. 660, p. 13-14.

[672] OECD, ref. n. 660, p. 13-14.

[673] The report only states that "*While these provisions are not specifically aimed at deductions with no corresponding inclusion for tax purposes, they may indeed impact on them by denying the deduction at the level of the payer.*" OECD, ref. n. 660, p. 14.

[674] OECD, ref. n. 660, p. 14-21.

specifically addressing hybrid mismatch arrangements regarding DD outcome, D/NI outcomes, and foreign tax credit generators.[675] However, these examples mostly deal with dual tax residence situations.[676] The report briefly describes an experience with the application of such rules and mentions the possibility of introducing a *tie-breaker* test to avoid the circularity of applicable rules.[677] The report concludes that countries should (i) consider enacting specific and targeted rules denying benefits in the hybrid mismatches arrangements cases, (ii) share intelligence on how to tackle and monitor hybrid mismatches arrangements, and (iii) enact rules requiring disclosure of hybrid mismatch arrangements.[678]

Key takeaways from reading the 2012 report are that (i) the OECD uses the term *hybrid mismatch arrangements* to discuss some set of hybrid mismatches, (ii) the OECD has started to emphasize tax revenues, competition, economic efficiency, fairness, and transparency as key tax policy concerns challenged by hybrid mismatch arrangements, and (iii) the OECD has discarded some solutions to hybrid mismatch arrangements based on only a few arguments that have already become obsolete. The OECD has thus probably limited solutions suggested to hybrid mismatch arrangements in subsequent reports. Hence, I think this opens a door for debate on whether better solutions to hybrid mismatch arrangements are still on the table or not.

In the 2013 report[679], the OECD expresses its view that hybrid mismatches are one of the key areas which the BEPS Project has to deal with.[680] The 2013 report lists anti-hybrid rules, "*which link the domestic tax treatment with the tax treatment in that foreign country thus eliminating the possibility for mismatches*", as one of the anti-avoidance rules relevant for the purposes of the BEPS Project[681] and lists some forms of hybrid mismatches such as hybrid entities[682], D/E HFIs, and hybrid transfers using the term *hybrid instruments*.[683] Interestingly, the 2013 report mentions hybrid mismatch arrangements as MNE's tax planning device to achieve low or no taxation.[684]

In 2014, the OECD delivered an interim report which summarized what solution the OECD had taken toward hybrid mismatch arrangements and their outcomes.[685] The 2014 report showed that the OECD took a pragmatic approach toward hybrid mismatch arrangements and that since the

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675 OECD, ref. n. 660, p. 15-21.
676 OECD, ref. n. 660, p. 15-21.
677 OECD, ref. n. 660, p. 24.
678 OECD, ref. n. 660, p. 25.
679 OECD. *Addressing Base Erosion and Profit Shifting*. Paris: OECD, 2013. DOI: https://doi.org/10.1787/9789264192744-en. ISBN 9789264192744.
680 OECD, ref. n. 679, p. 6, 7, 10, 47.
681 OECD, ref. n. 679, p. 38.
682 OECD, ref. n. 679, p. 6, 7, 40.
683 OECD, ref. n. 679, p. 6, 7, 40-41.
684 OECD, ref. n. 679, p. 6, 7, 73.
685 OECD, ref. n. 329. For the discussion of the OECD reports from 2012 until 2014 and shortcomings of the predominantly domestic solution, see BRAUNER, Yariv, ref. n. 11, p. 18-21.

OECD had previously ruled out harmonization as a practically impossible solution to the hybrid mismatch arrangements issue, the main solution is going to consist of amendments to domestic law and tax treaties.[686] The domestic law should use linking rules to deal with outcomes of hybrid mismatch arrangements and implement a few other recommendations.[687] In regard to tax treaties, the OECD proposes "*changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly*"[688] and to reflect amendments to domestic laws due to the Action 2 recommendations.[689] Also, the OECD published changes to the OECD Model Tax Convention in Action 6 which can affect tax outcomes of hybrid financial instruments and hybrid entities, *e.g.* limitation-on-benefits rule, rule dealing with arrangements having the main aim to obtain treaty benefits.[690]

The 2015 report wraps up the previous reports and brings the final solution as part of the BEPS Project. The 2015 report brings two sets of recommendations.[691] The first set of recommendations concerns amendments to domestic law.[692] The second set of recommendations deals with improvements of tax treaties so "*hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I*".[693] The report makes it clear that the scope of the recommendations is hybrid mismatches leading to D/NI outcomes, DD outcomes, and indirect D/NI outcomes.[694]

The OECD has thus decided to focus more on dealing with the outcomes of the hybrid mismatch arrangements over dealing with differences in the tax treatment of hybrid entities, hybrid financial instruments, and hybrid transfers. What is the solution the OECD suggests? Mainly specific amendments to domestic law and the use of linking rules, *i.e.* linking particular hybrid mismatch arrangements with its outcome and denying the tax benefit (deduction or not taxing an item of income) if a DD, D/NI or imported D/NI outcome is present because of such hybrid mismatch arrangement.

The OECD BEPS Action 2 solution of hybrid mismatches is based primarily on linking rules.[695] The linking rules analyze the arrangement giving rise to a hybrid mismatch if there is some

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[686] OECD, ref. n. 329, p. 11-21.
[687] OECD, ref. n. 329, p. 27-76.
[688] OECD, ref. n. 329, p. 24.
[689] OECD, ref. n. 329, p. 77.
[690] OECD. *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report.* Paris: Organisation for Economic Co-operation and Development, 2015, p. 9-11. ISBN 978-92-64-24169-5.
[691] OECD, ref. n. 20, p. 11-12.
[692] OECD, ref. n. 20, p. 13-132.
[693] OECD, ref. n. 20, p. 12.
[694] OECD, ref. n. 20, p. 16-21.
[695] Nevertheless, the OECD 2015 report suggests also other recommendations. See OECD, ref. n. 20, p. 16, par. 5.

non-taxation outcome, linking rules amend the outcome in a way that allows for *formal* single taxation instead of non-taxation. The linking rules do not deal with low-taxation situations because they apply only in DD or D/NI cases. To enact linking rules, the OECD recommends countries to enact them into their tax law primary rules (responses) and defensive rules to prevent the unwanted outcome of hybrid mismatch arrangements.[696]

The aim of linking rules is to deal only with outcomes of hybrid mismatch arrangements that countries might consider unwanted from the tax policy perspective. This expressly stated concern with DD outcomes, D/NI outcomes, and imported D/NI outcomes is paramount for the subsequent discussion of why and how to deal with hybrid mismatches (arrangements) from the perspective of countries' tax policy. I have shown above that scholars and politicians state that double non-taxation outcome may be an outcome that *is* desirable (or at least irrelevant) from the tax policy perspectives of particular countries. However, if there are countries that want to deal with this issue, they have to come up with a solution. As I summarize later in this chapter, the linking rules are not a perfect solution, but its wide support shows that countries actually desire to get rid of double non-taxation outcomes in hybrid mismatches arrangements cases. And if this is the case, countries need instruments allowing them to prevent an occurrence of these outcomes they consider unwanted from their tax policy perspective. Linking rules are certainly not the most effective option but they show what is the goal of tax policy of the OECD and countries who adopt these rules. And, if such countries want to deal with hybrid mismatches (arrangements) in a more effective manner, then I think other solutions discussed in the subsequent chapter are better.

Tax law considers as an arrangement that is a hybrid mismatch arrangement still as legal. Linking rules only change the tax outcome of hybrid mismatch arrangements. From this point of view, linking rules should take precedence over other anti-abuse rules because they are dealing with a situation that is specifically tackled by the linking rules, *i.e.* rules specifically created to deal with hybrid mismatch arrangements. On top of that, according to the OECD, countries should apply linking rules regardless of a taxpayer's intention which is unusual for application of GAARs which consider the subjective aspect of transactions. Nevertheless, scholars criticize the fact that linking rules do not contain a subjective criterion and argue in favor of using linking rules as a solution of last resort and *after* taking into account all specific anti-avoidance rules, in particular CFC rules and thin capitalization rules, to avoid possible double taxation.

[696] Reason behind this is that the OECD is issued BEPS Project Reports in a form of recommendations that are non-binding according to Article 5(b) of the Convention on the Organisation for Econonomic Co-operation. Therefore, the OECD has to consider possibility of some countries not implementing recommendations at all or to some extent. See *e.g.* PEETERS, Bart, ref. n. 485, p. 439. ; OECD. Convention on the OECD. *OECD* [online]. Paris: Organisation for Econonomic Co-operation and Development, 2020 [cit. 2020-08-02]. Available at: https://www.oecd.org/about/oecd-convention.htm.

The OECD divides linking rules[697] into three sets of recommendations. The first set of recommendations deals with D/NI outcomes. The second set of recommendations deals with DD outcomes. The third set of recommendations deals with imported D/NI outcomes.

Recommendations 1 and 2 deal primarily with D/E HFIs leading to D/NI outcome.[698] The general solution toward these situations is the use of the primary linking rule and the defensive linking rule.[699] The primary linking rule states that in the case of a payment stemming from the D/E HFI a payer jurisdiction has to "*deny a deduction for such payment to the extent it gives rise to a D/NI outcome*".[700] If the payer jurisdiction does not apply the primary rule, the OECD recommends using the defensive rule that states that payee jurisdiction should include the income into the payee´s tax base.[701] The OECD Action 2 Report limits the use of these two linking rules to cases where payer jurisdiction does not include the income within a reasonable period of time.[702] These linking rules apply only to payments under a financial instrument and substitute payments[703] under arrangements to transfer a financial instrument that result in hybrid mismatches and are among related persons or taxpayers who are parties to the structured arrangement.[704]

Using the basic model example of D/E HFI, linking rules apply in the following way. Primarily, the payer jurisdiction, *i.e.* Country B, denies the interest deduction of BCo.

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[697] The OECD BEPS Action 2 contains recommendations that narrow a scope of linking rules to situations including related persons, control group or structured arrangement. See recommendations 1.4, 3.4, 4.4, 6.4, and 8.4 in connection to recommendations 10, 11, and 12. I have decided to do so to for the sake of the clarity of the argument. However, I acknowledge that these limitations to the scope have proven to be problematic in practice. In relation to the ATAD's implementation see *e.g.* KLEIN, Christoph and Marcus MICK. Germany's Proposed Anti-Hybrid Rules. *Tax Notes International*. 2020, 2020(July 20, 2020), p. 371-372.

[698] See OECD, ref. n. 20, p. 25, par. 19, and p. 45-47.

[699] Recommendation 1.1(a) and 1.1(a).

[700] Recommendation 1.1(a). See *e.g.* OECD, ref. n. 20, p. 25.

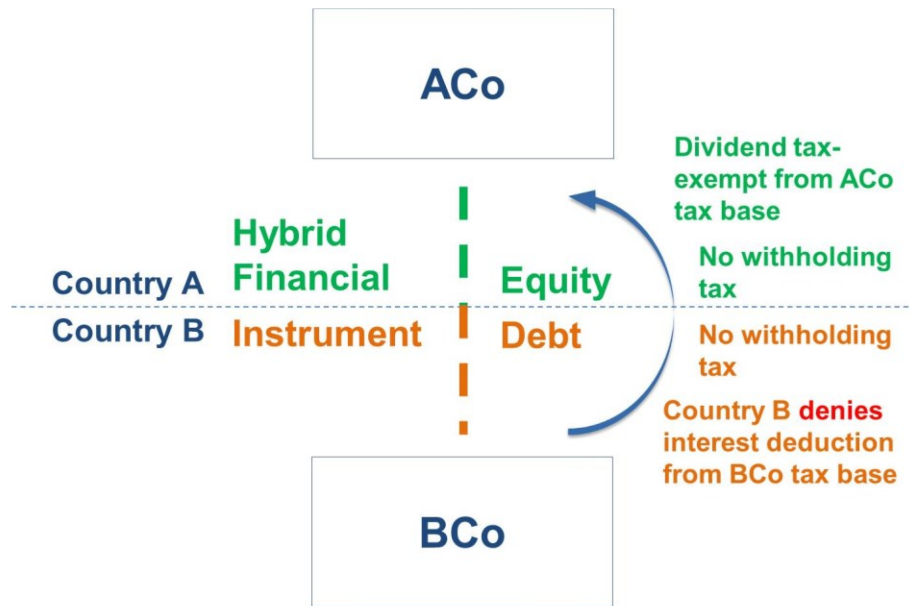
[701] "*If the payer jurisdiction does not neutralize the mismatch then the payee jurisdiction will require such payment to be included in ordinary income in ordinary income to the extent the payment gives rise to a D/NI outcome.*" Recommendation 1.1(b). See *e.g.* OECD, ref. n. 20, p. 25.

[702] Recommendation 1.1(c).

[703] The report states that the substitute payment appears "*where the transferee receives a payment in substitution for the financing or rquity return on the transferred asset (a substitute payment)*". OECD, ref. n. 20, p. 26. See Example 1.34 of the report for a practical example. OECD, ref. n. 20, p. 269-271.

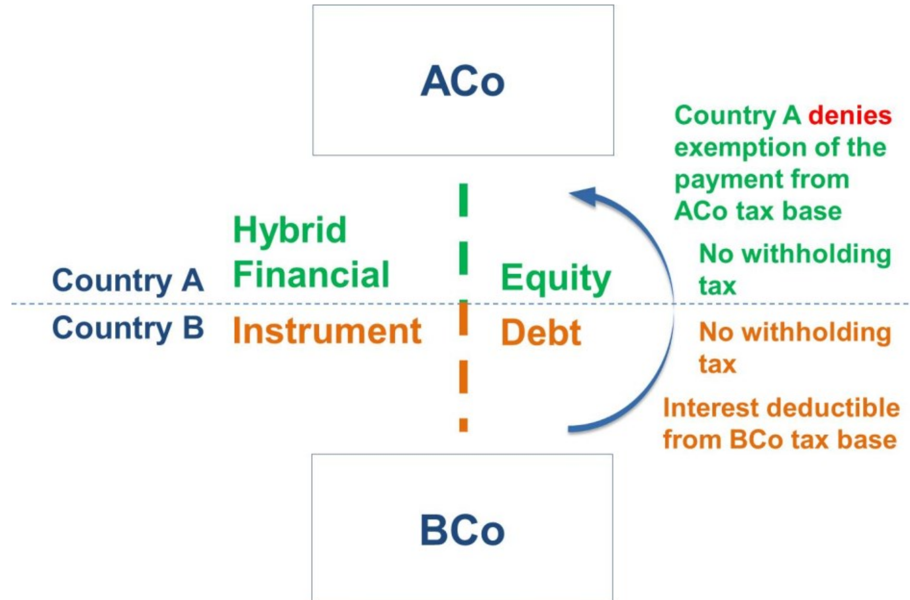
[704] Recommendation 1.1-4.

Figure 29 *Application of Recommendation 1.1(a) - Primary Response*



If the payer's jurisdiction does not deny the interest payment deduction, the payee's jurisdiction must include the payment into the ACo tax base, *i.e.* Country A taxes ACo's dividend income that would be otherwise tax-exempt.[705]

Figure 30 *Application of Recommendation 1.1(b) - Defensive Rule*



[705] The defensive rules thus recalls of the switch-over clause (see below) because "*state should no longer grant an exemption but include the payments in the tax base of the recipient*". RUST, Alexander. BEPS Action 2: 2014 Deliverable Neutralising the Effects of Hybrid Mismatch Arrangements and its compatibility with the non-discrimination provisions in tax treaties and the Treaty on the Functioning of the European Union. *British Tax Review*. 2015, 2015(3), p. 12. ISSN 0007-1870.

In addition to linking rules, the OECD Action 2 Report recommends countries (i) not to grant "*dividend exemption or equivalent tax relief for payments that are treated as deductible by payer*" in general, and (ii) to limit "*the ability of a taxpayer to claim relief from foreign withholding tax on instruments that are held subject to a hybrid transfer*".[706] The first recommendation targets rules that alleviate double economic taxation by, for instance, participation exemption.[707] This exemption should not apply when the payee may deduct such payment from its tax base.[708] The second recommendation targets rules that grant taxpayers foreign tax credits under hybrid transfers because the application of these rules may lead to exploitation of foreign tax credits generators which the OECD obviously does not want from its tax policy perspective.[709]

The OECD suggests the solution to hybrid transfers in Recommendations 1 and 2.[710] If Recommendation 1 does not apply, countries should apply Recommendation 2, *i.e.* to "*restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement*".[711] Laguna emphasizes that the OECD does not limit the scope of Recommendation 2.1 whereas linking rules in Recommendation 1 have their limited.[712] Recommendation 2.1 thus subsidiarily shifts tax revenues to a payee jurisdiction, *i.e.* residence states.[713] Laguna, quoting Schön, argues against this and prefers source taxation, *e.g.* using withholding taxation.[714] The OECD illustrates the application of Recommendation 2.2 regarding hybrid transfers in Example 2.2.[715]

In Example 2.2, two taxpayers conclude a bond lending arrangement which is a hybrid transfer and thus their residence countries allow them to apply for foreign tax credit on a withholding tax from a third country.[716]

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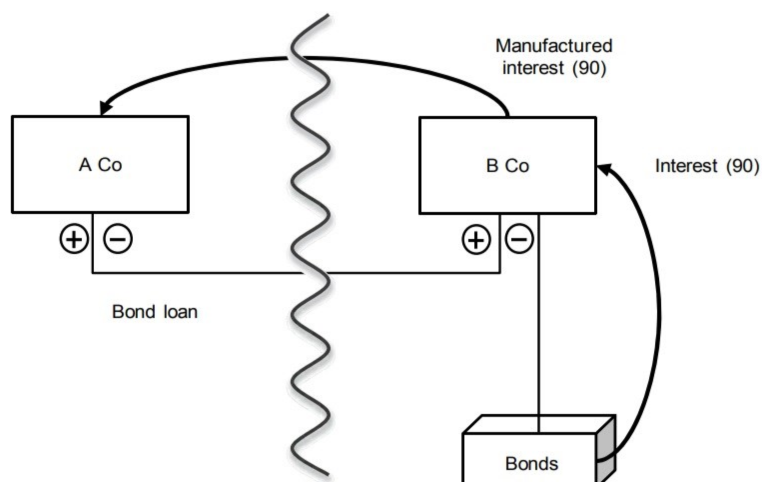
[706] Recommendation 2.1-2.
[707] OECD, ref. n. 20, p. 46-47.
[708] OECD, ref. n. 20, p. 46-47.
[709] OECD, ref. n. 20, p. 47.
[710] Recommendations 1.2(b) and 2.2.
[711] Recommendation 2.2. See also Example 2.2.
[712] MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 256.
[713] This is also a solution that the EU has implemented in Article 4 of the amended PSD. MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 256-257.
[714] Navarro, Parada, and Schwarz suggested using withholding taxation instead, too. NAVARRO, Aitor, Leopoldo PARADA and Paloma SCHWARZ, ref. n. 36, p. 130. Laguna further proposes to amend the IRD and the PSD in that way. MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 256-257.
[715] See Examples 1.32 and 2.2 and the illustration of share lending agreement in Chapter 3.
[716] The BEPS Action 2 report states that „*the instrument loaned under the arrangement is a bond rather than a share. B Co is the "borrower" under the arrangement with obligations that include the requirement for B Co to pay A Co the amount of any interest payments that are paid on the underlying bonds (net of any withholding taxes) during the period of the loan (the "manufactured interest payment"). The net economic effect of this arrangement is that A Co continues to be exposed to the full risk and return of holding the bonds, through the obligations owed by B Co under the arrangement*". OECD, ref. n. 20, p. 281, par. 1.

Figure 31 *Application of Recommendation 2.2 to a Bond Lending Arrangement in Example 2.2*[717]



The table in Figure 32 shows an illustration of how Country B and Country A could tax B Co and A Co. Country B does not recognize the transaction as a hybrid transfer and therefore allows B Co to use foreign tax credit for the whole withheld amount. However, Country A also allows A Co to apply for foreign tax credit for the amount withheld (see that tax credit of A Co is tantamount to the B Co's one).

Figure 32 *Tax Outcome Before Application of the Recommendation 2.2 in Example 2.2*[718]

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Manufactured interest	90	90	Interest	90	90
Amounts withheld	10	0	Amounts withheld	10	0
			Expenditure		
			Manufactured interest	(90)	(90)
Net return		**90**	**Net return**		**0**
Taxable income	**100**		**Taxable income**	**10**	
Tax on income (30%)	(30)		Tax on income (30%)	(3)	
Tax credit	10		Tax credit	10	
Tax to pay		(20)	Tax benefit		7
After-tax return		**70**	**After-tax return**		**7**

However, if the Recommendation 2.2 applies, Country B restricts the maximum foreign tax credit usable by the B Co (see Figure 33). Thus, the B Co can use the foreign tax credit of only 3. Hence, the whole structure loses the excessive foreign tax credit of 7.

717 OECD, ref. n. 20, p. 281.
718 OECD, ref. n. 20, p. 282.

Figure 33 *Illustration of Application of the Recommendation 2.2 in Example 2.2*[719]

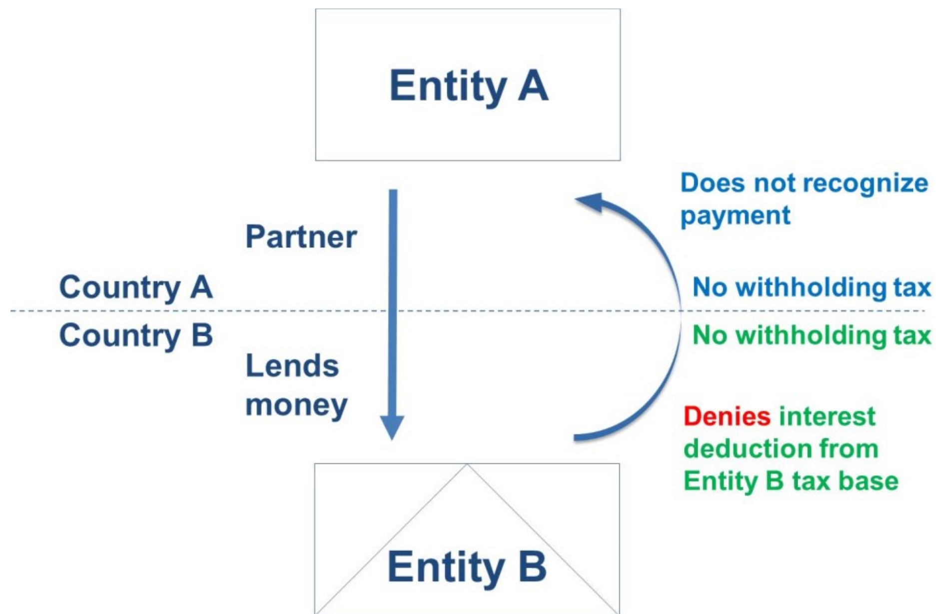
A Co			B Co		
	Tax	Book		Tax	Book
Income			Income		
Manufactured interest	90	90	Interest	90	90
Amounts withheld	10	0	Amounts withheld	10	0
			Expenditure		
			Manufactured interest	(90)	(90)
Net return		**90**	**Net return**		**0**
Taxable income	**100**		**Taxable income**	**10**	
Tax on income (30%)	(30)		Tax on income (30%)	(3)	
Tax credit	10		Tax credit	3	
Tax to pay		(20)	Tax to pay		0
After-tax return		**70**	**After-tax return**		**0**

The OECD recommendations 3, 4, and 5 deal with hybrid entities giving rise to D/NI outcomes.[720] Liking rules dealing with these outcomes are similar to linking rules dealing with hybrid financial instruments; *i.e.* the primary rule states that payer jurisdiction should deny a deduction of a disregarded payment made by hybrid payer leading to a hybrid mismatch and the defensive rule stipulates that payee jurisdiction should include such payment into payee´s tax base in the case the payer jurisdiction does not apply the primary rule.[721] Specific rules apply to dual inclusion income and to the excess deduction situations.[722] The former rule aims to avoid double taxation due to the use of linking rules and the latter rule prevents further double non-taxation outcomes. Linking rules apply only to parties to the mismatch that are in the same control group and to taxpayers who are parties to the structured arrangement.[723]

Using the basic model example of a hybrid entity, linking rules apply in the following way. Primarily, the payer jurisdiction, *i.e.* Country B, denies the interest deduction of BCo (see Figure 34).[724]

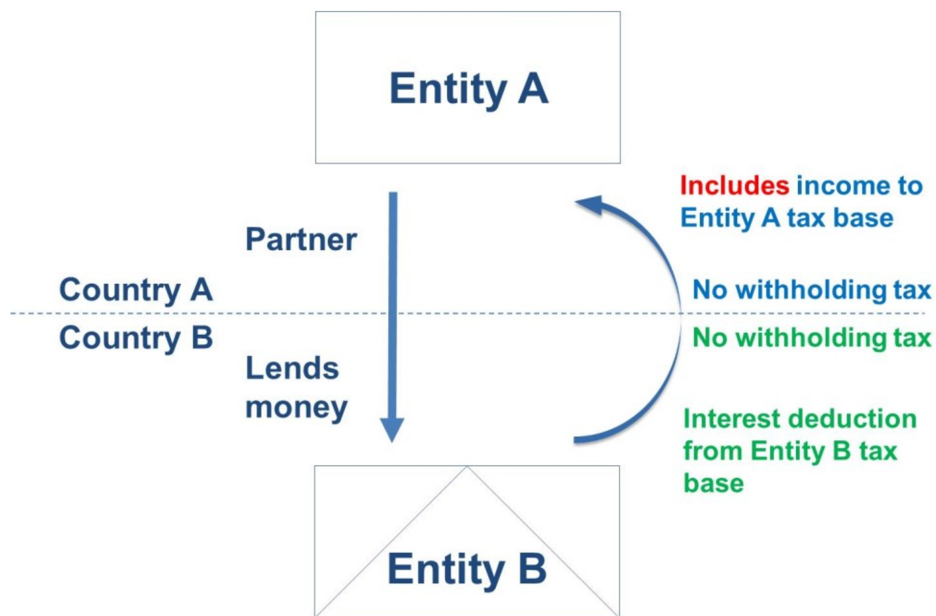
[719] OECD, ref. n. 20, p. 283.
[720] Recommendations 3.1, 4.1, and 5.1. See *e.g.* OECD, ref. n. 20, p. 156-158.
[721] Recommendation 3.1(a), (b).
[722] Recommendation 3.1(c), (d).
[723] Recommendations 3.4 and 4.4.
[724] For a discussion of application of this rule, see also *e.g.* PARADA, Leopoldo, ref. n. 29, p. 981-982.

Figure 34 *Application of Recommendation 3.1(a) – Primary Response*



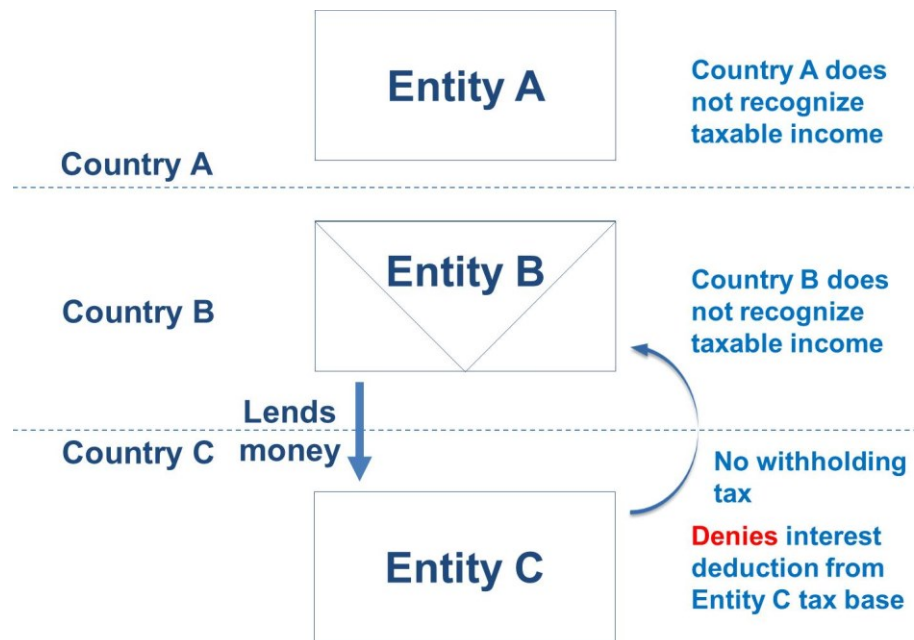
If Country B does not deny the interest deduction, the defensive rule applies (see Figure 35).

Figure 35 *Application of Recommendation 3.1(b) – Defensive Rule*



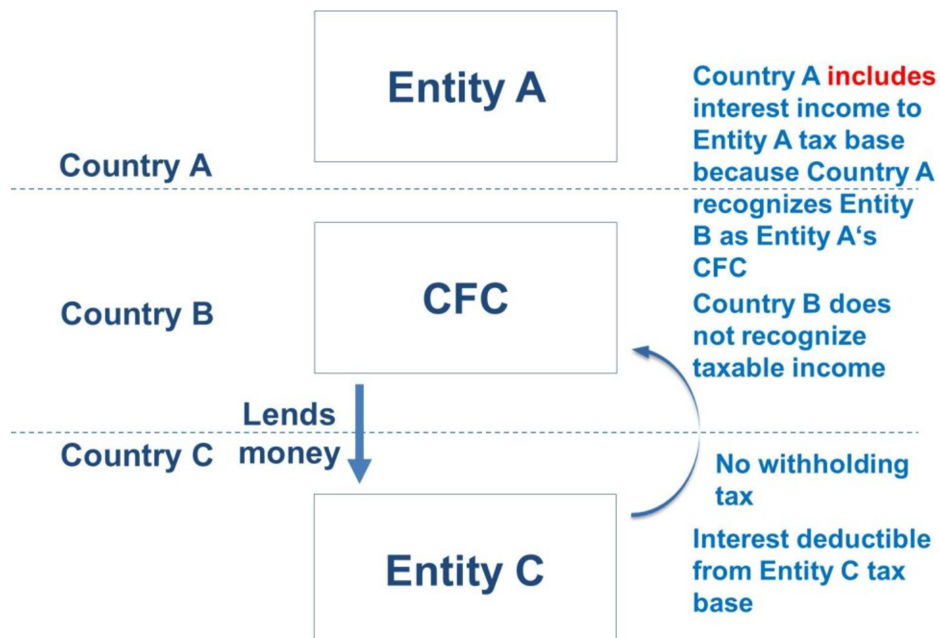
Using the basic model example of a reverse hybrid entity, Recommendation 4.1 applies in the following way.

Figure 36 *Application of Recommendation 4.1 to Reverse Hybrid Entity – Primary Response*



Interestingly, the OECD does not recommend a defensive rule. Instead of using the defensive rule, the OECD suggests to countries in Recommendation 5.1 to introduce or amend CFC rules and similar rules to prevent D/NI outcomes arising out of reverse hybrid entities.[725]

Figure 37 *Application of Recommendation 5.1 to Reverse Hybrid Entity Situation*



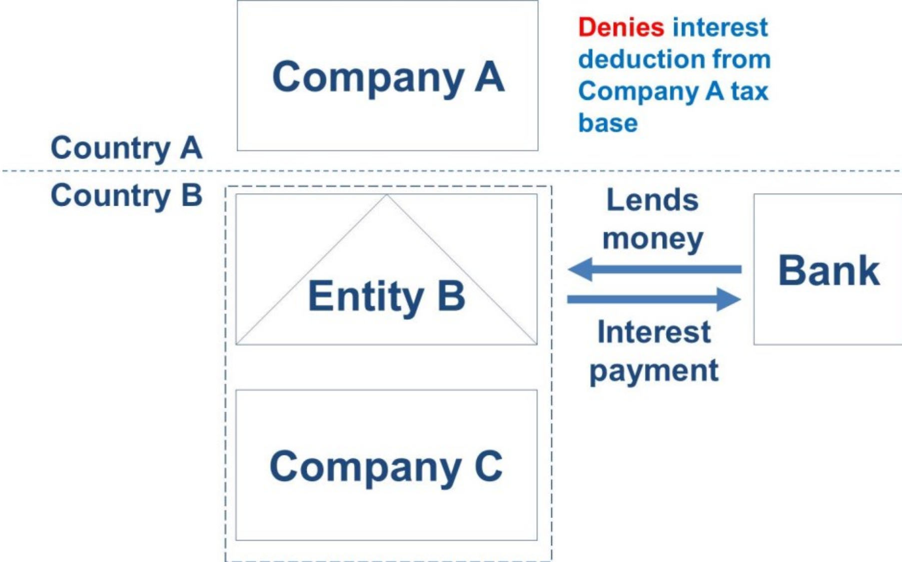
[725] For a discussion of this rule and its possible shortcomings, see *e.g.* PARADA, Leopoldo, ref. n. 29, p. 982. See also OECD, ref. n. 20, p. 57, par. 149.

Surprisingly, the OECD recommends also the use of the coordination rule in Recommendation 5.2. The OECD suggests enacting a rule that would turn a fiscally transparent entity to (partially) fiscally non-transparent.[726] The OECD includes an explanation that countries grant fiscal transparency, *e.g.* to a collective investment scheme, because countries presume that the income will be ultimately taxed in hands of investors.[727]

Recommendation 6 deals with payments of hybrid entities that give rise to a DD outcome. Primarily, the parent jurisdiction should deny the duplicate deduction for a payment that leads to a duplicate deduction in the parent jurisdiction and results in a hybrid mismatch. The defensive rule shifts the duty to deny the deduction to the payer jurisdiction if the parent jurisdiction does not use the primary rule.

The recommended rules apply to the DD outcome examples in the following way (see Figure 38 and Figure 39).

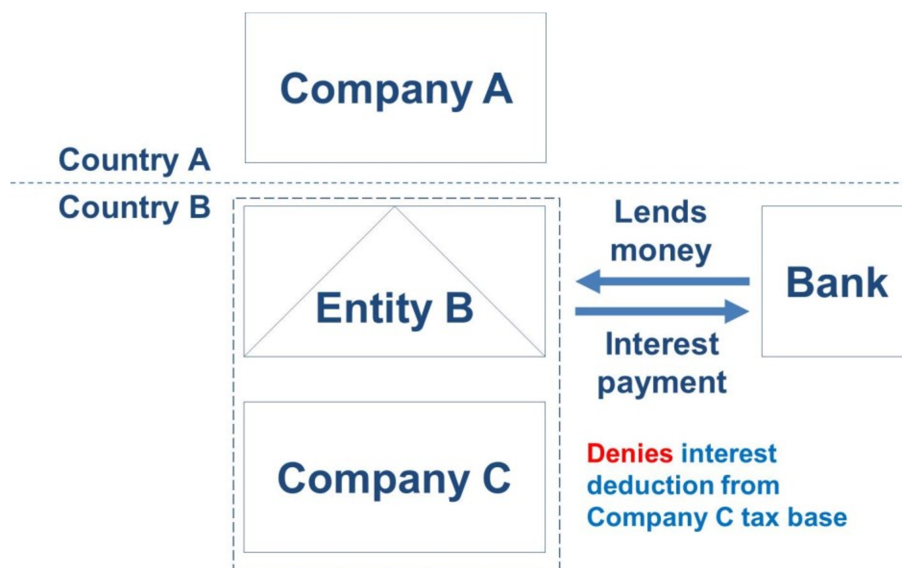
Figure 38 *Application of Recommendation 6.1(a) to the DD Outcome Scenario – Primary Response*



[726] For a discussion of application, similarities to the Danish solution, and concerns regarding legal certainty and possibility of discrimination, see PARADA, Leopoldo, ref. n. 29, p. 990-992.

[727] OECD, ref. n. 20, p. 64, par. 174.

Figure 39 *Application of Recommendation 6.1(b) to the DD Outcome Scenario – Defensive Rule*



Since tax planners can plan around linking rules dealing with D/NI outcomes by using jurisdictions that have not enacted rules preventing hybrid mismatch arrangements, the OECD recommends[728] enacting a rule that prevents such structures.[729] The imported mismatch rule states that the payer jurisdiction should "*apply a rule that denies a deduction for any imported mismatch payment to the extent the payee treats that payment as set-off against a hybrid deduction in the payee jurisdiction*".[730] According to the OECD, the payment can mean "*a broad range of payments (including interest, royalties, rents and payments for services)*".[731] However, such payment must have a link to hybrid mismatch, *i.e.* the income from such payment must be "*set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement*".[732] The rule applies not only to the taxpayers who are part of the same group but also to payments made under the structured arrangements.[733]

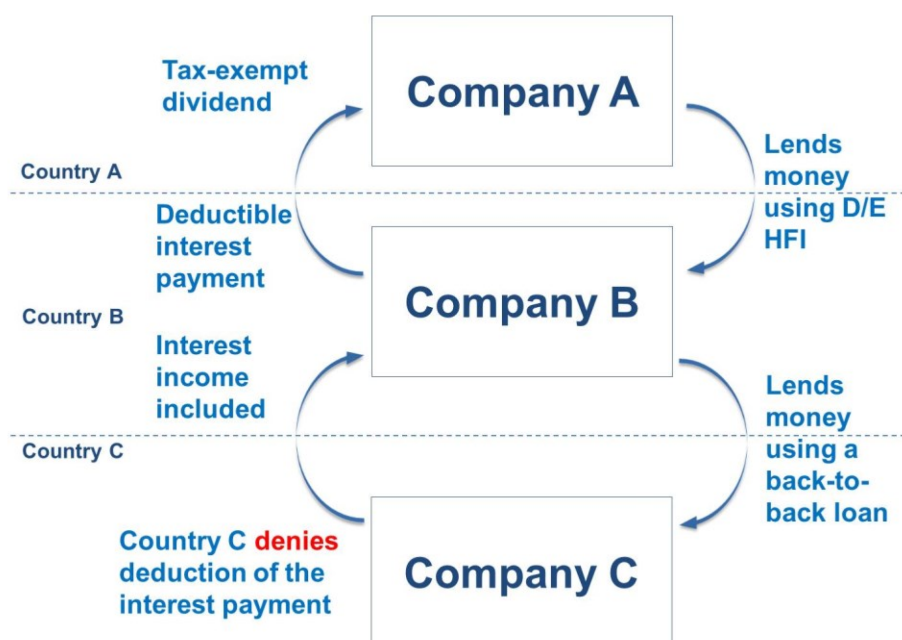
The imported mismatch rule consists of three tracing and priority rules.[734] The conditions for their application starts with finding (i) a direct hybrid deduction[735], *i.e.* hybrid mismatch arrangement leading a D/NI or DD outcome,[736] (ii) an imported mismatch payment, *i.e.* "*a deductible payment, made by a taxpayer that is subject to the hybrid mismatch rules, and which is included in ordinary income under the laws of*

[728] Recommendation 8.1.
[729] OECD, ref. n. 20, p. 83-84, par. 234.
[730] Recommendation 8.1.
[731] OECD, ref. n. 20, p. 83-84, par. 234. In a similar manner, Peeters writes that "*Any transfer of value involving the exchange of economic rights between parties can be considered, as long as it generates ordinary taxable income for the receiver, which will subsequently be neutralized making use of a hybrid mismatch*". PEETERS, Bart, ref. n. 485, p. 441. In a similar manner, see also OECD, ref. n. 20, p. 85, par. 242.
[732] OECD, ref. n. 20, p. 83-84, par. 234.
[733] Recommendation 8.4.
[734] OECD, ref. n. 20, p. 84, par. 235. ; OECD, ref. n. 20, p. 86, par. 246-247.
[735] Recommendation 8.2.
[736] OECD, ref. n. 20, p. 84, par. 235.

the payee jurisdiction", and (iii) nexus between this payment and that hybrid deduction, *i.e.* directly or indirectly financing the direct hybrid deduction.[737] If this is true, the imported mismatch rules then apply in a specific order.[738] Firstly, the question is if the deduction can be attributed to "*a payment made under a structured arrangement*".[739] If no, then the question is, whether there is a direct imported mismatch.[740] If not, the last applicable rule should prevent the indirect imported mismatch payment.[741]

Using the basic model example of direct imported mismatch leading to D/NI outcome, linking rules apply in the following way (see Figure 40).

Figure 40 *Application of the Imported Mismatch Rule - Illustration*



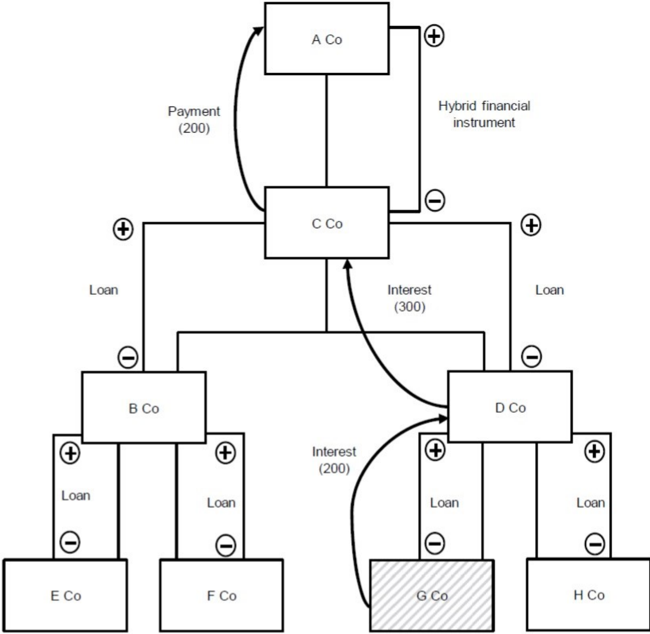
Company A and B concluded a D/E HFI. Therefore, Company B can deduct interest payment that Country A exempts from taxation, *i.e.* hybrid deduction is present.[742] In this example, there is not a structured arrangement. However, Company A, B, and C are all part of the same control group. Therefore, the first rule dealing with structured arrangement does not apply but the rule dealing with direct imported mismatch applies in Country C. This country denies deduction of

737 OECD, ref. n. 20, p. 85, par. 241.
738 ALLEN, Christina, ref. n. 481, p. 4 [online].
739 OECD, ref. n. 20, p. 84, par. 236.
740 OECD, ref. n. 20, p. 84, par. 237.
741 OECD, ref. n. 20, p. 84-85, par. 238-239.
742 Recommendation 8.2(a).

interest of Company C because the income resulting from this payment directly leads to the hybrid deduction in Country B using an apportionment approach.[743]

Using a more complex structure described in Example 8.5,[744] the rule also applies to *indirect* imported mismatch payments (see Figure 41). In this example, ACO and CCo concluded a D/E HFI. CCo and DCo concluded a back-to-back loan and subsequently also DCo entered into a back-to-back loan with GCo. The arrangement includes a hybrid financial instrument giving rise to a direct hybrid deduction (the D/NI outcome) between ACo and CCo. Can Country G deny the deduction of GCo? Firstly, the structured imported mismatch rule does not apply because the whole transaction is not part of the structured arrangement. Secondly, DCo does not apply a direct imported mismatch rule to CCo and DCo loan. Therefore, Country G, the country where GCo is tax resident, should apply the imported mismatch rule dealing with a payment indirectly financing the D/E HFI hybrid mismatch.

Figure 41 *Illustration of Indirect Hybrid Mismatch Situation in Example 8.5*[745]



Theoretically, if all countries would implement the recommendations, the D/NI situations would lead to taxation in the country of residence, the DD situations would lead to taxation in the source country, and imported D/NI situations would lead to taxation in the country with either (i) providing direct financing to the imported hybrid mismatch or (ii) the most advanced tax administration authority able to assess complex arrangements and find a necessary nexus. However,

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743 OECD, ref. n. 20, p. 84, par. 237. For an example describing the application of the apportionment approach, see *e.g.* Example 8.4. OECD, ref. n. 20, p. 352-354.

744 OECD, ref. n. 20, p. 355-359.

745 OECD, ref. n. 20, p. 355.

the OECD does not explain how this hypothetical situation leads to taxation where value is created. Nevertheless, such a situation is theoretical. In practice, it is not certain that all countries will adopt these rules and, if yes, it will surely take time to implement the recommendations, especially to the developing countries.[746] Thus, on the one hand, the ultimate distribution of taxation of hybrid mismatch arrangements is somewhat random.

On the other hand, all of the above examples of using linking rules lead to one outcome, *i.e.* *formal* single taxation somewhere. I say *formal* because the OECD's recommendations do not state *how much* should a country tax the outcome of the hybrid mismatch. Such reasoning, if it is, is only implicit. Therefore, it seems that country should include income or deny deduction and tax the proceeding by its statutory tax rate. But, since the linking rules pursue *some* taxation, tax planners can devise schemes to tax plan around linking rules. The OECD linking rules also have other loopholes as I discuss later in relation to the ATAD.

Thus, the linking rules are blind in regards of what the actual taxation is if it is above *zero*. And even that is not completely true because linking rules do not apply in some situations where countries do not tax some taxpayers at all, *i.e.* their CIT statutory tax rate is 0 %.[747] This ultimately means that the BEPS Action 2 linking rules do not aim to lead to *substantial* single taxation, *i.e.* single taxation above a certain threshold, but the tax policy aim is to attain *formal* single taxation.

To sum up, linking rules apparently deal only with outcomes of hybrid mismatch arrangements and try to prevent double taxation only to the extent in which linking rules themselves could create such outcome but not mostly not if there is a concurrent application of other anti-abuse rules.

5.3. The ATAD's Linking Rules: Shrug It Off in the EU

The EU has been dealing with double taxation as well as double non-taxation for several years.[748] However, the discussion has become intense concurrently with the OECD's anti-BEPS

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[746] For a case study of possible difficulties with the BEPS Action 2 implementation in developing countries, see *e.g.* KUZNIACKI, Blazej a others. Preventing Tax Arbitrage via Hybrid Mismatches: BEPS Action 2 and Developing Countries. *WU International Taxation Research Paper Series*. 2017, 2017(3), p. 1-47. DOI: http://dx.doi.org/10.2139/ssrn.2941617.

[747] KOLLRUSS, Thomas. Is ATAD a Black Hole? The Impact on International Tax Planning. European Taxation. Amsterdam: IBFD, 2019, 59(8), p. 380-381.

[748] See *e.g.* Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - Co-ordinating Member States' direct tax systems in the Internal Market. COM (2006) 823 final. ; COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE Double Taxation in the Single Market. COM(2011) 712 final. Also, the Article 293 of the TFEU used to deal with double taxation situations.

debate.[749] In 2011, the European Council issued its Conclusions where the European Council called EU Member States participating in the Euro Plus Pact for a "*pragmatic coordination of tax policies*".[750] In 2012, the D. G. Taxation and Customs of the European Commission issued The Internal Market: Factual Examples of Double Non-taxation Cases document for discussion which lists double non-taxation examples and assesses them as unwanted because these situations lead to unfairness, to tax revenue losses, and to competition distortions.[751] Since 2012, the EU has been dealing with the double non-taxation issue[752] and the Council of the European Union has decided to come up with a solution to *aggressive tax planning*.[753]

Following the publication of the BEPS Project Action 2 Report in 2015, the European Parliament had asked the Commission to present a solution to hybrid mismatches based either on harmonization or linking rules.[754] Subsequently, the Commission presented its Anti-Tax Avoidance Package on January 28, 2016, which included a proposal of the ATAD containing an explanatory memorandum.[755] The proposal mentions the BEPS Project several times.[756] However, the proposal based its solution to hybrid mismatches on coordination rules[757] between EU Member States stating that an approach toward third countries had to be further discussed.[758] The coordination rule scope covered only hybrid entities and hybrid financial instruments and stated that EU Member State must follow the tax legal characterization of the source EU Member State.[759] On April 20, 2016, the

[749] For the thorough description of the EU debate and incorporation of the BEPS Action 2 regarding the hybrid financial instruments see *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 217-261.

[750] See EUROPEAN COUNCIL 23/24 JUNE 2011 CONCLUSIONS, EUCO 23/11, p. 3-4.

[751] Staff working paper, The internal market: factual examples of double non-taxation cases TAXUD D1 D(2012), p. 3-5.

[752] See *e.g.* Code of Conduct. On the Code of Conduct on transfer pricing documentation see *e.g.* HELMINEN, Marjaana, ref. n. 83, p. 315-324.

[753] For a substantial critique of the concept see *e.g.* PARADA, Leopoldo, ref. n. 8, p. 44-50.

[754] See *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 155.

[755] Proposal for a COUNCIL DIRECTIVE laying down rules against tax avoidance practices that directly affect the functioning of the internal market. COM (2016) 26 final.

[756] See *e.g.* COM (2016) 26 final, ref. n. 755, p. 3-6, 9-10.

[757] "*In order to ensure that Member States introduce rules to effectively combat against these mismatches, this Directive prescribes that the legal characterisation given to a hybrid instrument or entity by the Member State where a payment, expense or loss, as the case may be, originates shall be followed by the other Member State which is involved in the mismatch.*" See COM (2016) 26 final, ref. n. 755, p. 9.

[758] See rec. 11 of the proposal, COM (2016) 26 final, ref. n. 755, p. 13, stating that "*it is necessary to limit the scope of these rules to hybrid mismatches between Member States. Hybrid mismatches between Member States and third countries still need to be further examined*".

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

Where two Member States give a different legal characterisation to the same payment (hybrid instrument) and this leads to a situation where there is a deduction in the Member State in which the payment has its source without a corresponding inclusion of the same payment in

European Economic and Social Committee delivered its opinion on the Commission's proposal.[760] The opinion expresses a view that the ATAD should follow the OECD work on the BEPS Project and should prevent fragmentation of legal responses.[761] On June 8, 2016, the European Parliament gave an opinion on the first reading stating approval to the draft but suggested amendments to the proposal.[762] The amendments included an expansion of the scope of the anti-hybrid mismatches rules using coordination rules in transactions between EU Member States and linking rules in the relationships between the EU Member State and a third country.[763] Concurrently to the proposal, opinions, and consultation, the Council of the European Union had run the discussion process which ended in an agreement on June 17, 2016. Unfortunately, the agreed-on version of the ATAD changed the solution from coordination rule to linking rule without explaining why the Council changed the solution.[764] On that day, the Council[765] had enacted the ATAD I which became effective on August 8, 2016.[766] However, the ATAD I did not include the original coordination rules but instead used linking rules to deal with hybrid mismatches between EU Member States.[767] The ATAD I also did not include rules dealing with hybrid mismatches between EU Member States and third countries with the explanation that further examination is necessary.[768] This limitation was a serious loophole that rendered these rules ineffective because hybrid mismatches can arise among

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the other Member State, the legal characterisation given to the hybrid instrument by the Member State in which the payment has its source shall be followed by the other Member State." Article 10 of the proposal in COM (2016) 26 final, ref. n. 755, p. 21.

[760] Opinion of the European Economic and Social Committee on the proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation (COM(2016) 25 final — 2016/0010 (CNS)) and the proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (COM (2016) 26 final — 2016/0011 (CNS)).

[761] See *e.g.* points 1.2, 1.3, 1.11, 3.2, 3.3 and 3.4.

[762] See European Parliament legislative resolution of 8 June 2016 on the proposal for a Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (COM (2016) 0026 – C8-0031/2016 – 2016/0011(CNS)).

[763] See amendments n. 77-81 in COM (2016) 26, ref. n. 762. The amendment 81 suggested inserting the Article 10 having two paragraphs and stating that (i) "*Where a hybrid mismatch between a Member State and a third country results in a double deduction, the Member State shall deny the deduction of such a payment, unless the third country has already done so*" and (ii) "*Where a hybrid mismatch between a Member State and a third country results in a deduction without inclusion, the Member State shall deny the deduction or non-inclusion of such a payment, as appropriate, unless the third country has already done so*".

[764] See 3475e session du Conseil de l'Union européenne (AFFAIRES ÉCONOMIQUES ET FINANCIÈRES), tenue à Luxembourg, le 17 juin 2016, p. 4. ; IDN 10324/16 PRESSE 35 RÉSULTATS DE LA SESSION DU CONSEIL 3475e session du Conseil Affaires économiques et financières Luxembourg, le 17 juin 2016, p. 4, briefly summarizing that "*Le Conseil a examiné, en vue de dégager un accord politique, un projet de directive visant à répondre à certaines des pratiques les plus couramment utilisées par les grandes entreprises pour réduire leur charge fiscale. Au vu de la discussion, la présidence a présenté un texte de compromis final. Le président du Conseil a pris acte du fait que la quasi-totalité des États membres étaient en mesure d'approuver le texte. La présidence a donc annoncé une procédure de silence jusqu'au 20 juin 2016, à minuit*".

[765] See Chapters 2 and 8 on the discussion about the Article 115 of the TFEU procedure.

[766] The ATAD I has been published in the Official Journal of the EU on July 19, 2016 and the Article 12 of the ATAD I states that the directive "*shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union*".

[767] Article 9 of the ATAD I states that "*To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment*".

[768] See recital 13 of the ATAD I Preamble.

any countries and thus it was easy to tax plan around linking rules contained in the ATAD I provisions. Hence, the Council asked the Commission to continue with work on hybrid mismatches and to "*to put forward a proposal by October 2016 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 BEPS report on Action 2, with a view to reaching agreement by the end of 2016*".[769] Therefore, the Commission proposed an amendment to the ATAD I on October 25, 2016,[770] and attached to it a staff working document discussing the economic and political context of hybrid mismatches and their examples.[771] The explanatory memorandum to the ATAD II explicitly mentions that "*Elements of this Directive draw upon the OECD Report on Neutralising the Effects of Hybrid Mismatch Arrangements which was part of the OECD/G20 BEPS Project*".[772] The Council had adopted the final version of the amendment to the ATAD I on May 29, 2017 and the ATAD II became effective on June 27, 2017.[773] The ATAD II has broadened the scope of the ATAD to include hybrid mismatches between EU Member States and third countries as well as (hybrid) permanent establishment mismatches, hybrid transfers, imported mismatches, and dual resident mismatches.[774]

The ATAD deals with hybrid mismatch arrangements in a similar manner as the OECD BEPS Action 2, *i.e.* the ATAD uses primarily[775] linking rules to deal with hybrid mismatches

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[769] See 2016/0011 (CNS), p. 33. The document also included a draft statement of the Council and the Commission linking the ATAD I to the OECD BEPS Project and its recommendations in general writing that "*The objective of the Directive is to ensure a coordinated and coherent implementation at EU level of the OECD's recommendations regarding base erosion and profit shifting (BEPS), which would enhance the single market by introducing a harmonized minimum standard. However, by transposing the OECD's recommendations into a legally binding instrument the EU goes further than the OECD approach. In order to avoid any unintended consequences and ensure that the EU is not placed at a competitive disadvantage relative to its trading partners, the Member States and the Commission will closely monitor the implementation of the BEPS recommendations at global level. The Member States and the Commission should actively engage with the OECD to promote swift, effective and inclusive implementation of BEPS recommendations in order to ensure a level playing field at international level*".

[770] See COM (2016) 687 final Proposal for a COUNCIL DIRECTIVE amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

[771] See SWD (2016) 345 final COMMISSION STAFF WORKING DOCUMENT Accompanying the document Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries {COM (2016) 687 final}. The explanatory memorandum to the ATAD II explains that to "*provide a qualitative analysis a separate Staff Working Document (SWD) accompanying this Directive gives an overview of existing findings on hybrid mismatch arrangements based on recent studies by the OECD and the European Commission. The SWD highlights the most common identified mechanisms which are linked to hybrid mismatch arrangements. Furthermore, the SWD addresses the objectives and features of this Directive.*" See COM (2016) 687 final, ref. n. 770, p. 5.

[772] See COM (2016) 687 final, ref. n. 770, p. 4.

[773] Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries. *EUR-Lex* [online]. Brussels: EU, 2017 [cit. 2020-08-30]. Available at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=uriserv:OJ.L_.2017.144.01.0001.01.ENG.

[774] See COM (2016) 687 final, ref. n. 770, p. 3. ; Articles 2, 9. 9a and 9b of the ATAD.

[775] The only exception is reverse hybrid entities situations where the rule in the Article 9a of the ATAD orders EU Member States to disregard fiscal transparency of a reverse hybrid entity. The Article 9a par. 1 states that "*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*".

outcomes instead of dealing with different tax definitions in domestic law. This approach does not deal with the core reason for hybrid mismatches' occurrence, *i.e.* the different tax characterization, and avoids the harmonization of definitions of particular tax terms.[776]

To sum up, the European Parliament suggested to the European Commission using either harmonization of tax terms (core solution) or dealing only with the outcomes (linking rules solution). The draft of the ATAD contained harmonization of tax terms but this solution was later changed to linking rules. The ATAD's linking rules are mostly based on the OECD BEPS Action 2 linking rules and preparatory documents and the ATAD II preamble support this claim.[777]

The ATAD's preamble makes it clear that the tax policy reasoning behind the ATAD is that the EU[778] wants to "*restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty*".[779] The solution using linking rules limits states tax sovereignty less than the solution using harmonization of tax terms but also brings to life other issues criticized by academics (see below).

The ATAD rules generally apply only to taxpayers who are subject to corporate income tax and their permanent establishments.[780] Fiscally transparent entities are generally excluded from the scope of the ATAD with an exception of reverse hybrid entities.[781] A crucial feature of the ATAD is that it creates a minimum standard,[782] *i.e.* EU Member States can enact stricter rules dealing with tax schemes unwanted from their tax policy perspective in corporate income taxation.[783] The ATAD enumerates what hybrid mismatches are subject to its linking rules.[784] The ATAD states that all hybrid mismatches resulting in DD outcome are within its scope,[785] but contains a closed list of six hybrid mismatches situations resulting in D/NI outcome which are within ATAD´s scope.[786]

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776 See *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 153. ; FIBBE, Gijs, ref. n. 379, p. 418. ; FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 166.

777 See *e.g.* Recitals 1, 2, 5, 7, and 8 of the ATAD II's Preamble.

778 All EU Member States since every one of them had to consent with this directive.

779 Recital 1 of the ATAD I Preamble.

780 Article 1(1) of the ATAD. Alas, this creates a space for tax planning strategies using individuals. See for a similar conclusion *e.g.* GOVIND, Sriram and Stephanie ZOLLES, Chapter 8 – The Anti-Tax Avoidance Directive. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 221, par. 606. This is a first problem of the ATAD because tax planning can utilize individuals to avoid application of ATAD's rules. See *e.g.* KOLLRUSS, Thomas, ref. n. 747, p. 378-379.

781 Articles 1(2) and 9a of the ATAD.

782 Article 3 of the ATAD.

783 See for a brief discussion of the minimal standard and a problem of heterogeneous implementation *e.g.* GOVIND, Sriram and Stephanie ZOLLES, ref. n. 227, p. 223, par. 612. ; DE LILLO, Francesco. The Impact of the EU Anti-Tax Avoidance Package on the Exercise of National Tax Sovereignty. PISTONE, Pasquale, ed. *European Tax Integration: Law, Policy and Politics*. Amsterdam: IBFD, 2018, p. 630-632. ISBN 978-90-8722-472-1.

784 Article 2(9) of the ATAD.

785 Article 2(9)(g) of the ATAD.

786 Article 2(9)(a)-(f) of the ATAD. On the discussion of the ATAD's subjective and objective scope see *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 157-160. ; MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 239-255.

Nevertheless, the ATAD allows two elective exclusions for EU Member States.[787] Although the ATAD sometimes uses different wording, the ATAD´s linking rules are similar to the OECD´s linking rules.[788]

Firstly, the ATAD deals with hybrid mismatches leading to DD outcome.[789] The rule is similar to the OECD BEPS Action 2 one. The primary rule demands the EU Member State which is the investor jurisdiction[790] to deny the deduction.[791] If the primary rule does not apply, the defensive rule demands the denial of the deduction in the EU Member State which is the payer jurisdiction.[792] The ATAD´s DD outcome linking rule also includes the rule preventing denial in the case of dual income inclusion.[793]

Secondly, the ATAD deals with hybrid mismatches leading to D/NI outcome.[794] The rule is similar to the OECD BEPS Action 2 one, too. The primary rule demands the EU Member State which is the payer jurisdiction to deny the deduction.[795] If the primary rule does not apply, the defensive rule demands the EU Member State which is the payee jurisdiction to include the income into the payee´s tax base.[796] This rule collides with the PSD rule which asks for taxation primarily by income inclusion in the payee's jurisdiction.[797] The PSD rule takes precedence over the ATAD linking rule in situations that the PSD covers.[798] Therefore, the PSD applies in situations of cross-border payment between EU Member States where the parent company holds more at least a 10 % "*stake in the capital of a company of another Member State*".[799]

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787 Article 9(4) of the ATAD.

788 The ATAD includes also the primary response and the defensive rule. In the EU area, all EU Member States should apply primary response, therefore the defensive rule should not be necessary. However, in relation to non-EU Member States, the use of defensive rules may be necessary. I am not dealing with all the details of ATAD's linking rules, in particular regarding the subjective scope of these rules, so for a discussion of the ATAD's rules, see *e.g.* GOVIND, Sriram and Stephanie ZOLLES, ref. n. 227, p. 235-240, par. 652-667. ; FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 165-166. ; POPA, Oana. Recent Measures to Counter Hybrid Mismatch Arrangements at the EU Level. *European Taxation*. 2017, 57(9), p. 401-406.

789 Article 9(1) of the ATAD. In relation to hybrid entities, see *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 161-162.

790 In BEPS Action 2 Recommendation 6.1(a) and (b) wording a *parent jurisdiction*.

791 Article 9(1)(a) of the ATAD.

792 Article 9(1)(b) of the ATAD.

793 The last sentence of Article 9(1) of the ATAD.

794 Article 9(2) of the ATAD. In relation to hybrid entities and reverse hybrid entities, see *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 162-165.

795 Article 9(2)(a) of the ATAD.

796 Article 9(2)(b) of the ATAD.

797 For an in-depth analysis of the PSD/ATAD interaction, see MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 256-261.

798 Recital 30 of the ATAD's Preamble states that "*Where the provisions of another directive, such as those in Council Directive 2011/96/EU (4), lead to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive*". On the discussion of the PSD scope and its relevance to the ATAD, see *e.g.* MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 259-261. Regarding a brief discussion of the PSD scope, see *e.g.* TENORE, Mario. The Parent-Subsidiary Directive. In: LANG, Michael, Pasquale PISTONE, Josef SCHUCH and Claus STARINGER, ref. n. 227, p. 145-164.

799 TENORE, Mario, ref. n. 798, p. 147, par. 434. Article 3(1)(a) of the PSD.

Thirdly, the ATAD deals with imported mismatches[800] and also follows the BEPS Action 2 recommendations.[801] However, Peeters shows that EU Member States have to use the BEPS Action 2 Final Report for further guidance.[802] The rule states that EU Member State has to deny the deduction to payment (see above) that *directly* or *indirectly* funds deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions.[803] This rule applies only in situations where other countries do not apply linking rules or similar rules leading to similar tax adjustments, *i.e.* EU Member States must apply this rule subsidiarily.[804]

Fourthly[805], the ATAD deals with hybrid transfers mismatches generating excess foreign tax credit in more jurisdictions.[806] Since the foreign tax credit generators do not involve deduction or non-inclusion, the rule cannot deny any deduction (or include an income). Instead, the rule stipulates that EU Member State shall limit the benefit of the relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved in proportion to the net taxable income regarding such payment. Thus, the rule works similarly to the OECD BEPS Action 2.[807]

Lastly[808], the ATAD includes a specific rule that aims to align the tax treatment of a reverse hybrid entity that is established in an EU Member State with its tax treatment in the jurisdiction of its investors. The rule states that such reverse 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*".[809] This rule therefore divides the ATAD's treatment toward reveres hybrid entities in an EU Member State and in a third country.[810]

To sum up, ATAD's linking rules considerably follow the OECD BEPS Project Action 2 recommendations. Thus, these linking rules establish *formal* single taxation. In addition, the EU anti-hybrid mismatches rules ultimately lead to the tax policy where the ATAD's linking rules demand taxation in the EU if a third country does not apply its anti-hybrid mismatches rules. However, if it is the case, then it is particularly difficult for tax administrators of EU Member States to link the

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800 Article 9(3) of the ATAD.

801 PEETERS, Bart, ref. n. 485, p. 438.

802 PEETERS, Bart, ref. n. 485, p. 450-451.

803 For the examples and differences between direct (Examples 8.2-4, 8.6, 8.7, and 8.10) and indirect (Examples 8. 5, 8.7-15) imported hybrid mismatch see *e.g.* OECD, ref. n. 20, p. 341-420.

804 However its subsidiary application is convoluted. See PEETERS, Bart, ref. n. 485, p. 440, 448-450.

805 Article 9(4) of the ATAD deals with branch mismatches but I do not analyze this rule because PE mismatches are outside of the scope of this work.

806 Article 9(6) of the ATAD. Article 9(2) of the ATAD covers hybrid transfers leading to the D/NI outcome.

807 In a similar manner and mentioning the on-market hybrid transfers, see *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 249-251.

808 The ATAD includes more rules they belong outside of the scope of the dissertation.

809 Article 9a(1) of the ATAD.

810 See *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 163-165.

outcome to, for example, imported mismatch payment and apply the linking rules. Nonetheless, the EU tax policy regarding hybrid mismatches is therefore *formal* single taxation "*no matter where*" but rather in the EU than nowhere.

However, even the ATAD's linking rules are not flawless. For example, Kollruss has described tax planning techniques available under the ATAD's linking rules that still lead to non-taxation, *e.g.* no-taxation/no-taxation scheme or no-taxation/quasi-no-taxation scheme.[811] Also, as I said above, other tax planning techniques can use *lower* taxation to avoid the application of linking rules.

5.4. Do Linking Rules Spell the Doom of Hybrid Mismatch Arrangements?

The aim of this subchapter is to show the pros and cons of linking rules and to argue that since linking rules bring too many shortcomings to legal systems, countries ought to use alternative solutions toward hybrid mismatches.

The above examples show that linking rules really prevent DD and D/NI outcomes in situations where the OECD wants to prevent them. Besides this effectiveness in avoiding pure non-taxation situations, the OECD states that the linking rules have a limited scope so these rules are comprehensive, targeted, and administrable.[812]

As regards the comprehensiveness and scope of the linking rules, the assessment depends upon the objective of the underlying tax policy. The linking rules certainly do not cover the whole universe of possible hybrid mismatches but deal only with the set that the OECD has labeled *hybrid mismatch arrangements* because the OECD considers this subset of hybrid mismatches exploitable for tax planning purposes.[813] Thus, the linking rules are comprehensive in relation to hybrid mismatch arrangements but not in relation to all hybrid mismatches. This is not necessarily a bad thing because the underlying aim of the linking rules is dealing with tax avoidance, although linking rules do not include any tax avoidance test. Therefore, the linking rules can apply to situations that do not constitute tax avoidance. This undermines the claim about the linking rules being properly targeted. The linking rules however seem to be comprehensive since they lead to *formal* single taxation. Nonetheless, as I have described in Chapter 4, international initiatives (including the BEPS Project) claim that they want to achieve that "*profits should be taxed where economic activities occur and where value is created*". The linking rules certainly do not achieve this because they apply regardless of these two

[811] For a discussion of tax planning using linking rules under the ATAD regime, see KOLLRUSS, Thomas, ref. n. 747, p. 377-381.
[812] OECD, ref. n. 20, p. 18-19.
[813] See *e.g.* OECD, ref. n. 20, p. 11.

circumstances and rather lead to "*taxation no matter where*"[814] which even a drafter of the OECD BEPS Project Action 2 Final Report has admitted.[815] In addition, the reason for the linking rules drafted the way they are is considering how countries are situated to prevent outcomes of hybrid mismatches.[816]

As regards the ease of tax administration, the linking rules are far from easily administrable which drafters of the OECD BEPS Project Action 2 admitted, too.[817] Other scholars have already dealt with this topic, but I would like to add some criticism from my experience as a tax bill's drafter concerned with tax policy and its enforcement. The linking rules are enormously difficult to administer for tax authorities and their enactment into income tax law brings many complications as well. The difficulty of administrability stems from various sources. Firstly, some countries had not dealt with hybrid mismatches in their practice before the BEPS Project. Hence, tax authorities of these countries, *e.g.* of the Czech Republic, have no previous wide-ranging experience with hybrid mismatches. Nonetheless, countries can tackle this issue by sharing experiences and further education. Secondly, the linking rules lead to issues regarding their applicability. The linking rules have to be written in a general way to include all necessary situations, however, such wording can also be too wide, which is a case of the Czech transposition (see Chapter 7). Thirdly, the application of the linking rules needs deep knowledge of foreign tax laws and ownership structures of taxpayers' groups and their activities. Countries have already been grappling with this lack of information and the BEPS Action 2 final report includes this recommendation, too. However, current solutions do not alleviate this problem right now and the use of future solutions is still dubious. Implicitly, the linking rules presume that tax administrators can process much information and have a deep knowledge of the legal environment in which taxpayers, in particular MNEs, operate.[818] Speaking from my own experience and experience of others[819], such implicit assumption is unreasonable and

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[814] See ref. n. 33.

[815] "*"We weren't thinking about where the income should be taxed," Peterson admitted*". SHEPPARD, Lee A. Anticipating EU Tax Haven Hybrid Rules. Tax Notes International. 2019, 2019(September 23), p. 1218.

[816] SHEPPARD, Lee A., ref. n. 815, p. 1218.

[817] Stating in general that taxpayers themselves are responsible for the application of linking rules and suggesting the tax administrators to "*make checklists and procedures*" to ascertain that taxpayers do not have arrangements leading to hybrid mismatches in place. SHEPPARD, Lee A., ref. n. 815, p. 1218-1219.

[818] To put it bluntly, how can the OECD and the EU expect the Czech tax administration to properly and fully enforce linking rules when the Czech Republic cannot even say on its own what income one has from their employment? I am not stating this to mock Czech administration but the problem with lacking digitalization of income taxation in the Czech Republic is well known and documented. For a thorough analysis in Czech, in particular slide 17 (weaknesses), see DELOITTE. 2016-GFR-studie-posouzeni-ADIS.pdf: Studie posouzeni stavajiciho danového IS Financní spravy CR. *Financni sprava* [online]. Praha: Financni Sprava, 2020 [cit. 2020-08-15]. Available at: http://www.financnisprava.cz/assets/cs/prilohy/f-novinky/2016-GFR-studie-posouzeni-ADIS.pdf.

[819] In a similar manner see *e.g.* Johnston quoting after 2014 draft Michael Plowgian ("*It will certainly be a challenge for developed countries and even more so for developing countries.*"), Richard Murphy ("*It is desperately complicated stuff in a lot of cases. How many people do these administrations have with the capacity to understand them, to draft rules, and actually get it through a legislature?*" and "*One of the things that both tax administrations and taxpayers will potentially struggle with* (…) *is getting the*

might lead to linking rules enforced occasionally or not at all even in the EU. Paradoxically, this could lead to further complexity because the question would arise whether the linking rules apply in situations where other country has a primary rule but does not enforce it or not.

To conclude, arguments of the linking rules' benefits are not persuasive and bring further questions and limitations. Thus, it seems that the only real advantage of linking rules is that they target and, at least in theory, prevent outright cases of DD and D/NI outcomes when the OECD wants to prevent them.

However, as regards the shortcomings of the linking rules, scholars and practitioners have criticized these rules for their complexity,[820] the excessive dependence on foreign laws,[821] the possibility of economic double taxation,[822] their artificiality,[823] circularity,[824] inherent presumption of abusive practices,[825] not respecting general principles of taxation,[826] leading to clashing issues with other anti-tax avoidance rules,[827] *e.g.* interest limitation rules and CFC rules,[828] breaching tax treaties' provisions (especially anti-discrimination provisions)[829] as well as EU law,[830] their ambiguity,[831] lack of clarity[832] and/or definition,[833] possibilities of different implementations,[834] interpretation and

information that's necessary to apply the rules.") and Chip Harter ("*There is potential for going from what may be double nontaxation today to effective double taxation*" due to the heterogeneity of implementation of the OECD linking rules). JOHNSTON, Stephanie Soon. Hybrid Mismatch Rules Challenge Developing Countries. *Tax Notes International*. 2014, 2014(April 28, 2014), p. 314-316.

820 The OECD itself in OECD, ref. n. 15, p. 15. Otherwise, see *e.g.* PARADA, Leopoldo, ref. n. 29, p. 982-985. ; PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 44. ; PEETERS, Bart, ref. n. 485, p. 451. ; ALLEN, Christina, ref. n. 481, p. 6 [online]. ; ATHANASIOU, Amanda, ref. n. 3, p. 1083, 1085.

821 See *e.g.* PARADA, Leopoldo, ref. n. 29, p. 985-986. ; PEETERS, Bart, ref. n. 485, p. 451. ; RUST, Alexander, ref. n. 705, p. 19. ; ALLEN, Christina, ref. n. 481, p. 5-6 [online].

822 See *e.g.* PARADA, Leopoldo, ref. n. 29, p. 986-987.

823 See *e.g.* PARADA, Leopoldo, ref. n. 8, p. 279-280.

824 See *e.g.* PARADA, Leopoldo, ref. n. 8, p. 312-313.

825 See *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 44. ; LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 148-150. ; PEETERS, Bart, ref. n. 485, p. 439. ; LAW, Shee Boon and Marjolein KINDS, ref. n. 425, p. 148.

826 For example, investors are responsible for taxation of their investment, *i.e.* it makes sense to switch linking rules dealing with D/E HFIs and primarily let countries to tax incoming payment. ATHANASIOU, Amanda, ref. n. 3, p. 1084.

827 In regard to the application of statutory or judicial anti-abuse rules to hybrid financial instruments, see *e.g.* LAW, Shee Boon and Marjolein KINDS, ref. n. 425, p. 136-142.

828 See *e.g.* PARADA, Leopoldo, ref. n. 29, p. 987-991. ; ATHANASIOU, Amanda, ref. n. 3, p. 1084-1085.

829 See *e.g.* PARADA, Leopoldo, ref. n. 8, p. 319-324.

830 See *e.g.* PARADA, Leopoldo, ref. n. 8, p. 325-342. ; LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 271-325. ; FIBBE, Gijs, ref. n. 379, p. 415-418. ; RUST, Alexander, ref. n. 705, p. 19. ; HELMINEN, Marjaana. EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements. *British Tax Review*. 2015, 2015(3), p. 325-339. ISSN 0007-1870. ; SANTOS, Ramon Tomazela. The Anti-Tax Avoidance Directive 2 and Hybrid Financial Instruments: Countering Deduction and Non-Inclusion Schemes in Third-Country Situations. *Bulletin for International Taxation*. 2018, 72(8), p. 518.

831 See *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 44-45. ; FIBBE, Gijs, ref. n. 379, p. 418.

832 See *e.g.* PEETERS, Bart, ref. n. 485, p. 448-451.

833 See *e.g.* LAGUNA, Félix Daniel Martínez, ref. n. 44, p. 137-147.

834 See *e.g.* ALLEN, Christina, ref. n. 481, p. 6 [online].

application,[835] and the possibility of giving rise to new forms of tax planning and tax avoidance.[836] Moreover, scholars criticize linking rules because they do not deal with the core reasons for their existence, *i.e.* the different characterization of reality by tax law,[837] and some scholars take the criticism even further and show that solution using linking rules misses the big picture.[838]

To conclude, linking rules have only few pros but many cons. Linking rules are hopefully only an interim solution that developed and developing countries should use cautiously, if at all. Therefore, scholars and tax policymakers should look further to find the optimal solution preventing hybrid mismatches and their outcomes.

The model examples of linking rules show that the linking rules lead only to *formal* single taxation because the rules achieve taxation in country which uses them first. Thus, the level of taxation is mostly irrespective of substantial level of taxation. For instance, the linking rule dealing with D/E HFI states that the payer jurisdiction ought to deny the deduction of interest payment. However, the benefits principle[839] claims that countries should tax passive income by the residence tax rate. As I explained above, the literature currently[840] considers the interest income as well as the equity income as the passive income. However, the linking rule assigns the taxation to the source country, not to the residence country, and also does not stipulate the tax rate. Therefore, the linking rules breach the current benefits principle and do not necessary lead to the *substantial* taxation. Such taxation is compliant with Avi-Yonah and Xu's suggestion to reverse the benefits principle.

To sum up, academics and practitioners have shown that ATAD linking rules might have a practical appeal and lead to *formal* single taxation outcome, but the solution is flawed.

5.5. Formal Single Taxation as a Legal Rule under EU Law and International Custom in the Area of Hybrid Mismatch Arrangements

As I showed above, the OECD BEPS Action 2 Recommendations regarding hybrid mismatch arrangements lead to strengthening *formal* single taxation no matter where while strengthening to some extent a position of residence jurisdictions. The implementation of these

[835] The level of complexity and difficulty in administering these rules should not be underestimated, nor should the costs for taxpayers in complying with these rules. HARRIS, Peter, ref. n. 314, p. 301.; GOVIND, Sriram and Stephanie Zolles, ref. n. 194, p. 223, par. 612. ; ALLEN, Christina, ref. n. 481, p. 6-7 [online].

[836] See *e.g.* PEETERS, Bart and Lars VANNESTE, ref. n. 340, p. 45. ; KOLLRUSS, Thomas, ref. n. 747, p. 377-381. ; SANTOS, Ramon Tomazela, ref. n. 830, p. 510.

[837] See *e.g.* FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 153. ; FIBBE, Gijs, ref. n. 379, p. 418. ; FIBBE, G. K. (Gijs) and A. J. A. (Ton) STEVENS, ref. n. 364, p. 166. ; SANTOS, Ramon Tomazela, ref. n. 830, p. 518.

[838] See *e.g.* HARRIS, Peter, ref. n. 314, p. 32-46.

[839] I use benefits principle for working purposes only because it relates to the single tax principle the most, but I could generally use any other criteria for the normative assessment of the substantial taxation.

[840] I am emphasizing it because, for example, Avi-Yonah writes that the royalty payments are in fact active-like even though double tax treaties and literature lists them among passive income. See *e.g.* AVI-YONAH, Reuven S., ref. n. 95, p. 16.

recommendations by the US, EU Member States[841], and other countries[842] combined with the MLI and amendment to the OECD DTC Model[843] can lead back to the single tax principle discussion.

In the EU, the question is whether the ATAD can survive the CJEU's scrutiny or not. If yes, the following question is, does the ATAD lead to *formal* single taxation in the area of hybrid mismatch arrangements? I think that this is the case. However, the most important caveat relates to the ATAD's scope. Thus, such legal rule applies only to situations covered by the ATAD.

Regarding public international law and the international tax arena, the question is whether the OECD BEPS Action 2 can lead to the establishment of an international custom in relation to hybrid mismatch arrangements. In general, as I wrote in Chapter 4, it is impossible to claim with certainty that there is any overall international tax regime established around international customs.[844] In particular, the rules recommended in the BEPS Action 2 Final Report would have to satisfy the definition of the international custom as laid down in the ICJ Statute, *i.e.* having an objective as well as the subjective element. Currently, both elements are questionable. The objective element depends upon the extent of implementation of BEPS Project Action 2 and how much will the practice vary.[845] Furthermore, the BEPS Project Action 2 prefers solutions to the hybrid mismatches issue using domestic linking rules. But, mere (and surely hypothetical) worldwide implementation of linking rules still does not constitutes international custom, if the *opinio juris* is lacking.[846] So far, there is evidence that some countries take BEPS Project Action 2 seriously.[847] However, the expression of the subjective element stating that countries consider themselves being legally bound to implement these rules is doubtful.[848]

5.6. Summary and Conclusion

I have shown in this chapter that the OECD and the EU have suggested domestic linking rules as a general solution to hybrid mismatches and their outcomes. This solution does not prevent hybrid mismatches from arising but deals only with their outcomes, *i.e.* DD outcome, D/NI

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[841] To this day, only Germany and Spain has not stated that they have implemented ATAD's linking rules. See EU. National transposition measures communicated by the Member States concerning:: Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries. *EUR-Lex* [online]. Brussels: EU Publications Office, 2020 [cit. 2020-08-20]. Available at: https://eur-lex.europa.eu/legal-content/EN/NIM/?uri=uriserv:OJ.L_.2017.144.01.0001.01.ENG.

[842] In relation to implementation of BEPS Action 1 by the EU, Australia, New Zealand, the United Kingdom, and the US, see *e.g.* BRABAZON, Mark, ref. n. 19, p. 310-314.

[843] BRABAZON, Mark, ref. n. 19, p. 304.

[844] For a discussion whether international taxation is part of international customary law, see GARCÍA, Elizabeth Gil, ref. n. 85, p. 330-333.

[845] Some extent of variability is acceptable for international custom to arise. See *e.g.* GARCÍA, Elizabeth Gil, ref. n. 85, p. 333. Also, a specific regional custom could arise. For example, between the US and the EU because both of them have implemented the BEPS Project Action 2.

[846] BENTIL, John, ref. n. 616, p. 1217.

[847] BRABAZON, Mark, ref. n. 19, p. 304.

[848] With the exception of EU Member States who must implement the ATAD.

outcome, and imported mismatch outcome. On paper, this solution looks effective and achieves the desired outcome, *i.e. formal* single taxation. This taxation is however "*no matter where*" which does not align with proclamations about value creation. Moreover, scholars have criticized linking rules heavily. Besides the theoretical shortcoming of linking rules, their practical usefulness is also dubious, in particular for countries with less advanced tax administration. Thus, linking rules now seem more like a steppingstone (for some a hurdle) to a final comprehensive solution to hybrid mismatches. Nevertheless, since EU Member States still must implement linking rules under the ATAD, it is necessary to find and implement alternative solutions to hybrid mismatch arrangements. Such solutions should help alleviate ramifications of linking rules and still be compatible with the ATAD, the PSD, and EU law as a whole. Hence, I show in the following chapter, what are the alternative solutions and discuss coordination rules as an alternative to linking rules.

6. As You Like It: Alternative Solutions to Hybrid Entities, Hybrid Financial Instruments, and Hybrid Transfers

6.1. Introduction

The purpose of this chapter is to show linking rules are not the only solution to hybrid mismatches and that other solutions can be a better alternative to linking rules. This illustration should also explain why countries may want to use coordination rules instead of linking rules and why it is advisable.

Firstly, I briefly describe alternative unilateral, bilateral, and multilateral solutions to hybrid mismatches. Then, I focus on coordination rules and analyze these rules as a solution to hybrid mismatches.

6.2. Overview of Other Solutions to Hybrid Mismatches

Tax policymakers and scholars have come up with several alternatives to linking rules. The most prominent solutions include unilateral solutions, *e.g.* coordination rules,[849] withholding taxation,[850] bilateral and multilateral solutions, *e.g.* coordination rules,[851] harmonization of definitions,[852] and amendments to double taxation reliefs, *e.g.* subject-to-tax clause, switch-over clause.[853]

Coordination rules are rules which aim to align the tax treatment of legal entities, financial instruments, and other elements of reality important for income taxation among countries so the disparities between jurisdictions in the characterization of these elements do not lead to outcomes which do not occur in domestic transactions, *e.g.* double taxation or non-taxation. The coordination rules can encompass unilateral, bilateral, and multilateral forms and sometimes blend with other solutions. Some countries already use coordination rules to deal with hybrid mismatches.[854]

Countries use withholding taxation in domestic as well as cross-border situations. Withholding taxation is essentially only a specific form of collecting taxes as opposed to filing a tax report. Countries use withholding taxation for instance when the payer is not a taxpayer in general or it can be difficult to assess the payee´s tax duty or collect such tax duty. Thus, specific

[849] See *e.g.* THURONYI, Victor, ref. n. 4, p. 1053-1060. ; REICH, Yaron Z. The Case for a "Super-Matching" Rule. *Tax Law Review*. 2012, 65(2), p. 241-311.

[850] See *e.g.* NAVARRO, Aitor, Leopoldo PARADA and Paloma SCHWARZ, ref. n. 36, p. 130. ; MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 256-257.

[851] See *e.g.* PARADA, Leopoldo, ref. n. 4, p. 353-398.

[852] See *e.g.* FIBBE, Gijs K. EC Law Aspects of Hybrid Entities. Amsterdam: IBFD, 2009, p. 395-396. ISBN 978-90-8722-042-6.

[853] For a discussion of the German approach, see *e.g.* KAHLENBERG, Christian. Prevention of Double Non-taxation: An Analysis of Cross-Border Financing from a German Perspective. *Intertax*. 2015, 45(3), p. 226-229.

[854] For example, Denmark in relations to hybrid entities and hybrid financial instruments. BUNDGAARD, Jakob. Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage – The Case of Hybrid Entities and Hybrid Financial Instruments. *Bulletin for International Taxation*. 2013, 67(4/5), p. 200-204.

withholding taxation does not help with dealing with a question of whether to tax some entity or payment or not. Therefore, withholding tax is only an instrument to achieve other solutions and I will not deal with this possibility further. However, withholding taxation can help with ensuring single taxation, *e.g.* country can enact conditional withholding tax that is relieved if the payee´s country taxes the payment.[855] The EU income tax directives limit the ability of EU Member States to raise withholding taxation in cross-border situations because such taxation affects the internal market.[856] Thus, it is currently largely unfeasible for EU Member States to deal with all hybrid mismatches using withholding taxation in cross-border situations between EU Member States until the EU changes its income tax directives.

Harmonization of definitions is similar to coordination rules because it also aims at achieving aligned tax treatment in both jurisdictions.[857] The difference is that the harmonization of definitions must be bilateral or multilateral. From public international law perspective, the devil dwells in the execution of this harmonization because countries would have to stipulate the definition in international treaties and then connect this definition with their domestic law. However, this could lead to many definitions in domestic law[858] unless the country has one unified definition for all cross-border situations. From the EU perspective, it makes more sense to come up with one unified definition of terms leading to mismatches in cross-border situations, *e.g.* in the form of a directive under Article 115 of the TFEU.[859] The problem is that this would have a great impact on EU Member States' tax sovereignty. That is probably the reason why the EU has decided not to come up with such a solution so far. Nevertheless, the formulary apportionment projects could ultimately lead to the harmonized definition of legal terms which lead to hybrid mismatches, *e.g.* the CCCTB Project in the EU. Under the formulary apportionment solutions, the EU Member States would use the same definitions to construct the corporate tax base of their corporate taxpayers which at least in theory could eliminate hybrid mismatches in the EU area.

Specific means to deal with hybrid mismatches include provisions which supplement double taxation reliefs, in particular the exemption method, and thus try to avoid non-taxation situations in cross-border settings. These two provisions are the subject-to-tax clause[860] and the switch-over

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[855] See *e.g.* NAVARRO, Aitor, Leopoldo PARADA and Paloma SCHWARZ, ref. n. 36, p. 130. ; MARTÍNEZ LAGUNA, Félix Daniel, ref. n. 44, p. 256-257.

[856] See *e.g.* Recital 3 and 8 of the PSD Preamble, Article 1 of the IRD.

[857] Thuronyi writes that harmonization of rules "*would be the most comprehensive way of dealing with arbitrage*". THURONYI, Victor, ref. n. 3, p. 1053.

[858] One definition for every treaty that has a definition that deviates from the domestic one or definitions in other treaties (legally binding instruments).

[859] See *e.g.* FIBBE, Gijs K., ref. n. 852, p. 395-396.

[860] The IBFD Glossary mentions the term to explain examples of limitation on benefits provision stating that limitation on benefits is a provision "*that may be included in a tax treaty to prevent treaty shopping, e.g. through the use of a conduit company. Such provisions may limit benefits to companies* (...) *that are not subject to tax in respect of the income in question ("subject-*

clause.[861] The former clause deals with situations where one state does not tax an income, despite having the right to tax based on the double tax treaty. In such circumstances, another state taxes that income under the subject-to-tax clause. Countries use the latter clause to protect their tax base when they use exemption as a means to alleviate double taxation, *e.g.* Germany,[862] but these states want to protect their tax base if the other state does not tax a cross-border income. However, states use both of these clauses in double tax treaties to deal with various unwanted outcomes, including outcomes of hybrid mismatches. Nevertheless, these clauses deal with outcomes (similarly to linking rules) but do not deal with the underlying issue of why hybrid mismatches exist in the first place.[863]

To conclude, until EU Member States come up or the EU itself comes up with a solution which includes formulary apportionment and/or harmonization of definitions of essential tax law terms, the only reasonable solution available for EU Member States might be a unilateral or bilateral use of coordination rules. Consequently, I analyze how countries can use coordination rules to tackle hybrid mismatches and asses if using coordination rules is a more viable tax policy option than using linking rules.

6.3. Overview of Coordination Rules

Coordination rules try to coordinate tax classification (tax treatment) of the taxpayer, financial instruments, ownership, and other aspects necessary to establish proper taxation across jurisdictions. The coordination rules can be unilateral, bilateral, or multilateral. Unilateral coordination rules have a form of domestic legal rules. Bilateral and multilateral coordination rules must be in a form in accordance with the international legal system, *e.g.* international convention, or supranational legal system, *e.g.* EU directive.

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to-tax approach")" [emphasis added]. The IBFD Glossary specifies the perception whether something is or is not subject to tax in these words: "*A distinction may be drawn between being subject to tax in the sense of being qualified as a taxpayer, and in the sense of specific income or capital being taxable. The former may be referred to as subjective tax liability and the latter as objective tax liability. Subjective liability (also commonly referred to as being liable to tax) is primarily relevant in the context of tax treaties as a factor in determining residence status. In this case, it is commonly understood as being subject to tax on worldwide income. Objective tax liability is increasingly used as a condition for providing double taxation relief under tax treaties. Confusingly, such income or capital may also be referred to as being "subject to" tax. In the latter case, it is sometimes unclear whether mere exercise of taxing authority in respect of the income or capital in question is sufficient or whether tax actually has to be paid*".

[861] The IBFD Glossary defines the term as "*Popular term to describe a mechanism provided in the double tax relief provisions of some treaties whereby the exemption method is replaced by the credit method under certain circumstances, e.g. where the income in question is not derived from active business operations. Switchover clauses may be seen as a mechanism for combating certain forms of tax avoidance.*" For a suggestion, see *e.g.* AULT, Hugh J., ref. n. 529, p. 1197.

[862] See *e.g.* KAHLENBERG, Christian, ref. n. 853, p. 226-229.

[863] Besides that, the EU-wide switch-over clause should have become part of secondary EU law in the ATAD but the rule has not been included into the final version of the ATAD I. See *e.g.* VAN HORZEN, Fred and Isabella DE GROOT. The Switch-Over Clause: To Exempt or Not to Exempt, That Is the Question. PISTONE, Pasquale and Dennis WEBER, ed. *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study*. Amsterdam: IBFD, 2018, p. 167-186. ISBN 978-90-8722-446-2.

Coordination rules can deal with hybrid mismatches in general or in particular. Thuronyi suggests the general approach "*to follow the domestic law characterization of a given country regarding a given cross-border transaction or entity*"[864] and then deals with its implementation in relation to hybrid entities, HFIs, and cross-border leases.[865] Thuronyi also adds that such an approach does not disturb the integrity of domestic tax rules while being "*more flexible than harmonization*" because these rules automatically react to changes in foreign tax law.[866] I agree with this conclusion because, as I wrote above, the underlying problem of hybrid mismatches is that they lead to inconsistencies that do not arise in domestic-only settings. Therefore, it makes sense to follow the domestic rules of other countries and aim to achieve a smooth transition of tax rules between borders. Also, it makes sense for a country that treats a foreign entity differently to amend its rules to prevent hybrid mismatch because that country is responsible for the mismatch.[867] However, the unilateral coordination approach can still lead to inconsistencies in triangular and more complex situations because they include foreign non-host countries. Thus, the more countries adopt coordination rules, the better. Ideally, only one all-encompassing coordination rule should apply, *e.g.* enacted in a form of an international tax treaty. Otherwise, the use of only coordination rules might ultimately lead to more complexity.[868]

6.4. Coordination Rules and Hybrid Entities

Coordination rules aim to align the treatment of entities as fiscally transparent or non-transparent by two or more jurisdictions in cross-border settings.

Parada discusses three general approaches towards coordination rules, *i.e.* the primacy of the source state, the primacy of the residence state, and the primacy of the home state.[869]

The primacy of the source state follows the tax treatment of the state where a relevant payment has its source.[870] Therefore, the tax treatment of a legal entity depends on whether the payment is from or to a hybrid entity or reverse hybrid entity.[871] Examples of this approach include the original proposal of Article 10(1) of the ATAD I[872] and tax practice of Spain.[873] However, Parada

[864] THURONYI, Victor, ref. n. 3, p. 1053. For an interesting debate about finding consistency in tax law by using matching rules, see REICH, Yaron Z., ref. n. 849, p. 304-309. ; ROIN, Julie A. Unmasking the "Matching Principle" in Tax Law. *Virginia Law Review*. 1993, 79(4), p. 813-861.
[865] THURONYI, Victor, ref. n. 3, p. 1053-1060.
[866] THURONYI, Victor, ref. n. 3, p. 1054.
[867] In a similar manner in relation to hybrid entities, see LÜDICKE, Jürgen, ref. n. 371, p. 13-14.
[868] In a similar manner, see *e.g.* THURONYI, Victor, ref. n. 3, p. 1054.
[869] Parada in his article discusses these approaches from multilateral perspective even though he supports his argumentation also using unilateral coordination rules. PARADA, Leopoldo. Hybrid Entity Mismatches: Exploring Three Alternatives for Coordination. *Intertax*. 2019, 47(1), p. 24-54.
[870] PARADA, Leopoldo, ref. n. 869, p. 26.
[871] PARADA, Leopoldo, ref. n. 869, p. 26.
[872] PARADA, Leopoldo, ref. n. 8, p. 172-177. ; PARADA, Leopoldo, ref. n. 869, p. 31-32.

shows that the application of such a coordination rule poses three hurdles.[874] First, there is a problem with the determination of the source state.[875] Second, such coordination rule can lead to a situation where the source country has to consider a foreign treatment which is contrary to the notion that the country responsible for a mismatching treatment should have primary responsibility for preventing the mismatch.[876] Third, some cases of application of the coordination rule can ultimately lower taxpayers' legal certainty.[877]

The primacy of the residence state aligns the tax treatment of an entity with its tax treatment in a state where the majority of its investors has tax residence.[878] Examples of this approach include the Danish tax law,[879] the OECD BEPS Project Action 2 Recommendation 5.2,[880] and, to some extent, the ATAD's reverse hybrid entity rule.[881] This approach also has some shortcomings, mainly lower legal certainty in some circumstances.[882]

The primacy of the home state follows the tax treatment in "*the country where the relevant entity is formally and legally established or incorporated, i.e. the home state*".[883] Examples of this approach include the CCTB Proposal,[884] the Spanish practice[885], and, to some extent, also the Czech practice.[886] Parada illustrates that even this approach has at least one flaw, *i.e.* "*the potential for a cherry-picking effect*".[887]

To sum up, Parada has suggested three potential coordination rules and argues that the optimal option is worldwide coordination which can be a feasible measure. The coordination rules that Parada has suggested bring some undesired effects but countries can deal with these outcomes using proper means during their implementation.

Thuronyi suggests using unilateral rule stating that "*an entity is treated as a corporation if it is a per se corporation or it is subject to corporate income tax by a country; and considered a resident by that country*".[888] Hence, countries could issue a list of corporations (legal persons) they consider fiscally non-transparent *per se*.[889] That would be helpful for tax administrators and taxpayers because they would know what legal forms are always fiscally non-transparent. Also, such a list is easy to amend. The

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873 PARADA, Leopoldo, ref. n. 8, p. 158-162.
874 PARADA, Leopoldo, ref. n. 869, p. 50.
875 PARADA, Leopoldo, ref. n. 869, p. 50.
876 PARADA, Leopoldo, ref. n. 869, p. 50.
877 PARADA, Leopoldo, ref. n. 869, p. 50-51.
878 PARADA, Leopoldo, ref. n. 869, p. 34.
879 See *e.g.* PARADA, Leopoldo, ref. n. 869, p. 34.
880 See above and PARADA, Leopoldo, ref. n. 869, p. 39-41.
881 Article 9a of the ATAD. PARADA, Leopoldo, ref. n. 869, p. 41-42.
882 PARADA, Leopoldo, ref. n. 869, p. 51-52.
883 PARADA, Leopoldo, ref. n. 869, p. 42.
884 Article 62(1) of the CCTB Proposal. PARADA, Leopoldo, ref. n. 869, p. 46-47.
885 PARADA, Leopoldo, ref. n. 869, p. 47-48.
886 See Chapters 2 and 7.
887 PARADA, Leopoldo, ref. n. 869, p. 52.
888 THURONYI, Victor, ref. n. 3, p. 1054.
889 THURONYI, Victor, ref. n. 3, p. 1054.

second condition proposes *the home tax supremacy* which follows the tax characterization of the taxpayer by its home country.

6.5. Coordination Rules and Hybrid Financial Instruments

The initial analysis of coordination rules dealing with hybrid financial instruments has to deal with two situations, *i.e.* incoming payment and outgoing payment. The incoming payment situation brings a possible form of coordination rule, *i.e.* to follow the tax characterization of the jurisdiction of the payer. Regarding the outgoing payment situation, countries could follow the tax characterization of a foreign country. However, that bilateral application would lead to a clash of coordination rules. Therefore, it makes sense to implement primarily only the incoming payment coordination rule in accordance with the principle that states entertaining a mismatch should take responsibility for dealing with the mismatch. To deal with the possibilities of mismatching coordination rule, Thuronyi suggests using the general rule stating that "*An instrument issued by a corporation is treated as equity if it is so treated by the corporation's state of residence*".[890] This rule would have to be accompanied by the tie-breaker rule to establish what state is the state of residence.[891] Ideally, both of these rules should be implemented on a worldwide uniform basis.

Regarding the practical implementation, some countries have already implemented coordination rules dealing with hybrid financial instruments, *e.g.* Denmark[892] and Germany.[893]

To sum up, coordination rules dealing with D/E HFIs are straightforward. The state can align its tax characterization of financial instruments based on the source of the payment and then enact a similar rule for the country of destination of the payment in cross-border settings. The examples from some countries also show that the implementation of coordination rules is a feasible solution to the D/E HFI issue.

6.6. Coordination rules and Hybrid Transfers

The analysis of coordination rules concerning hybrid transfers has to deal with the alignment of tax characterization of ownership of securities by the countries. Thuronyi suggests a specific coordination rule to cross-border leases. However, this approach can be extended to cover other situations of hybrid mismatches. He suggests a rule stating that "*the treatment of the transaction as a finance lease (whereby lessee is treated as the owner of the property for tax purposes) prevails over classification according to legal form*".[894] Using an analogy, it would mean preference of the economic ownership for

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[890] THURONYI, Victor, ref. n. 3, p. 1060.
[891] THURONYI, Victor, ref. n. 3, p. 1060.
[892] See *e.g.* BUNDGAARD, Jakob, ref. n. 854, p. 202-204.
[893] THURONYI, Victor, ref. n. 3, p. 1060.
[894] THURONYI, Victor, ref. n. 3, p. 1060.

repo arrangements. However, countries could use a rule stating that the tax characterization considers foreign treatment in case that the repo includes a foreign element. Again, the coordination rule dealing with hybrid transfers should ideally apply on a uniform worldwide basis.

6.7. Summary and Conclusion

To sum up, other authors have already come up with some suggestions of coordination rules. These rules bring some ramifications regarding their functioning but countries can deal with these ramifications more easily than with problems created by the linking rules and deal with the different tax characterization leading to hybrid mismatches. Therefore, the coordination rules seem to be a more viable tax policy than the linking rules. For EU Member States, beneficial thing is that coordination rules foster the principle of *mutual recognition* because EU Member States use tax treatment of other EU Member States under the coordination rules.

To conclude, tax policymakers should consider the implementation of coordination rules to deal with hybrid mismatches to avoid many side effects of the linking rules.

7. The Comedy of Errors: Implementation of the ATAD's Anti-Hybrid Rules in the Czech Republic

7.1. Introduction

This chapter discusses how Czech law dealt with hybrid mismatches prior the ATAD and how the Czech Republic has implemented the ATAD's linking rules.

The aim of this chapter is two-fold. On the one hand, I want to show how certain solutions are effective in preventing some instances of hybrid mismatches. On the other hand, I would like to point out to errors and loopholes in the ATAD's implementation that the Czech Republic ought to amend to avoid a breach of EU law and erosion of the CITA's integrity.

7.2. Before the ATAD's Implementation

The Czech Income Tax Act had not explicitly dealt with hybrid mismatches until the transposition of the ATAD. However, the CITA includes a few rules dealing with possible different tax characterization of taxpayers, items of income, and payment ownership or its outcomes for income tax law purposes. Also, the CITA and Czech Tax Process Code had not had explicitly stipulated any statutory GAAR. However, Czech courts had used a judicial GAAR as an implicit income tax law principle until the Czech Republic codified a statutory GAAR.[895] The statutory GAAR has been enacted into Czech tax law explicitly as a part of the transposition of the ATAD and has become a part of the Tax Process Code.[896] Thus, taxpayers and tax administrators could have dealt with potential hybrid mismatches only using the judicial pre-ATAD GAAR or specific provisions dealing with possible different tax characterization or its outcomes. These provisions are namely (i) the foreign corporate taxpayers coordination rule (*hybrid entities*), (ii) the administrative practice based on statements of the Ministry of Finance of the Czech Republic in relation to transparent entities (*hybrid entities*), (iii) the linking rule transposing the PSD tackling outcomes of some D/NI cases (*hybrid financial instruments*), (iv) debt/equity re-characterization rules (*hybrid financial instruments*), and (v) the provision stating that only the beneficial owner is entitled to the foreign tax credit benefits (*hybrid transfers*).

As regards hybrid entities, the CITA contains an explicit statutory coordination rule in relation to taxpayers who are foreign legal entities.[897] The CITA provides that an entity that is a

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[895] For a discussion of a GAAR in relation to the Czech Republic, see *e.g.* MORAVEC, Lukas and Danuse NERUDOVA. Czech Republic. LANG, Michael and al. GAARs - A Key Element of Tax Systems in the Post-BEPS World. Amsterdam: IBFD, 2016, p. 219-236. ISBN 978-90-8722-358-8. For a discussion about application of the Czech judicial GAAR, see *e.g.* KAMINKOVA, Petra. *Legislating against Tax Avoidance*. Prague, 2013, p. 24-40. Diploma Thesis. Charles University Faculty of Law.

[896] See Section 8 par. 4 of the Czech Tax Process Code. For a description and analysis of the new statutory GAAR the Czech Republic, see in Czech language *e.g.* HRDLICKA, Lukas and Petra SMIRAUSOVA, ref. n. 55, p. 14-20.

[897] See Section 17 par. 1 letter g) of the CITA. See also Chapter 2.

taxpayer under tax law of the state where such an entity is established is also a taxpayer for the CITA purposes. In practice, this means that if a foreign jurisdiction allows the establishment of a legal entity that does not have any general legal personality, *i.e.* the entity is not a legal person in civil law countries or is not a corporation in common law countries.[898] The CITA perceives such an entity as a taxpayer for the Czech corporate income tax purposes if the jurisdiction of the establishment of the entity perceives that entity as a taxpayer (*fiscally non-transparent*). In other words, the CITA uses *the home state tax categorization primacy* to prevent some situations of foreign *hybrid entities*. If a home state of such an entity is also the source state (*incoming payment*) or the residence state (*outgoing payment*), then the statutory coordination rule works in preventing hybrid mismatches from occurring between the Czech Republic and other countries. However, the still unresolved question is what the reasoning behind the current tax administration practice is and how it works in practice.[899]

Regarding hybrid financial instruments, the CITA had not contained any general rule. The CITA had only (i) transposed the amendment to the PSD to deal with some situations of deduction with tax exemption, *i.e.* leading to double non-taxation,[900] and (ii) with some situations of equity disguised as debt.

The CITA uses the *reversed* linking rule[901] which implements the amended PSD to avoid double non-taxation. That means that if EU Member State allows a deduction for a payment that represents an equity payment from the Czech perspective, the Czech payee must include this payment into its tax base. This rule however applies only to situations between the Czech Republic and other EU Member States and if the PSD conditions are met. For example, a German subsidiary sends a payment under a hybrid financial instrument to its Czech parent. The subsidiary deducts the amount paid as an interest payment because Germany classifies the hybrid financial instrument as an agreement on debt financing. The Czech parent company would under usual conditions exempt the equity income to prevent economic double taxation. But, since Germany allows the subsidiary to deduct the payment, the Czech Republic disallows the exemption and the Czech parent company therefore must include the payment into its tax base, *i.e.* the Czech Republic taxes the payment (denies the exemption).

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[898] THURONYI, Victor, ref. n. 4, p. 1055.
[899] See Chapter 2 and the discussion on administrative practice regarding German GmbH&Co KG.
[900] See Section 19 par. 1 letter zi) *in fine* of the CITA.
[901] Compare with the regular linking rule in the ATAD which demands primarily the payer´s jurisdiction to disallow a deduction.

The CITA also contains rules dealing with some earning stripping situations by denying interest deduction.[902] These rules can prevent some forms of outcomes of hybrid financial instruments.

In relation to hybrid transfers, the CITA also had not included any general provision dealing with these transfers explicitly. However, during the implementation of the ATAD, some state officials argued that the CITA already includes provisions that tackle mismatches in giving credit to taxpayers receiving a payment under a hybrid transfer. They argued that to achieve this outcome, the CITA uses a rule that states that only the *beneficial owner* of such payment is entitled to benefits, *e.g.* tax credit, under the CITA. In theory, this provision thus ought to alleviate the tax credit generator schemes in the case the Czech Republic is the resident country of the intermediary of the payment or of the resident who is the beneficial owner of such payment. Moreover, interestingly, the table reporting implementation of the ATAD by the Czech Republic refers only to Section 36 par. 1 of the CITA that deals with statutory income tax rates of withholding tax but certainly does not cover what taxpayer is entitled to a foreign tax credit.

So, is the argument legitimate? I do not think so. In practice, rules dealing with beneficial ownership do not prevent hybrid transfers because, speaking very broadly[903], both taxpayers fulfill the criteria of beneficial owners. The difference is not in who is an intermediary (or not), although sometimes the structure may look like a structure with a beneficial owner using an intermediary. In fact, under a hybrid transfer, a taxpayer who earns payment first qualifies as someone who has a legal title and is not a legal intermediary. Therefore, it is impossible to use the term beneficial owner to prevent all instances of hybrid transfers. Secondly, this rule does not prevent tax credit generator from arising when the Czech Republic provides a tax credit because the CITA considers the Czech taxpayer to be the beneficial owner of the payment but also another taxpayer who is not the tax resident of the Czech Republic and its country of tax residence gives this taxpayer a tax credit, especially in the case of tax sparing provisions. To sum up, this rule covers only a specific situation that deals with hybrid transfers, its application is uncertain and the rule is problematic because the scope of the term beneficial owner is unclear.

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[902] See *e.g.* Section 25 par. 1 letter zl) of the CITA.

[903] The issue of who is a beneficial owner in international taxation is puzzling. Firstly, various legal instruments define a term *beneficial owner* for their own purposes. For example, the OECD DTC Model has its own definition, the PSD and the IRD also have their own definitions, and domestic law can also contain some definition which can be related to double tax treaties, the PSD or the IRD, and other legal instruments, or not. The CJEU has dealt with this issue recently. For the newest CJEU case law stating that courts can use the OECD DTC Model as guidance, see *e.g.* CJEU, February 26, 2019, Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and Others v Skatteministeriet*. ECLI:EU:C:2019:134, par. 84-94. For a brief description of the recent development, see *e.g.* RIEGEL, Daniela and Stepan OSICKA. The concept of "beneficial owner" as seen by the ECJ. *Fucik & Partneri* [online]. Fucik & Partneri, 2019, May 16, 2019 [cit. 2020-08-02]. Available at: https://www.fucik.cz/en/articles/the-concept-of-beneficial-owner-as-seen-by-the-ecj/.

To sum up, the discussion of the rules above shows that the CITA was not well prepared to deal with hybrid mismatches prior to the implementation of the ATAD.

7.3. EU's Labour's Lost: The Implementation of the ATAD and Hybrid Mismatches

The transposition of the ATAD into the CITA follows the structure of the ATAD´s linking rules, *i.e.* the CITA newly contains linking rules dealing with DD outcomes[904], D/NI outcomes[905], and imported hybrid mismatches outcomes[906]. The CITA also contains the restrictions that deal with the time difference in the inclusion of the hybrid mismatch payment and with narrowing the scope only to associated persons.[907]

The provisions of the CITA newly dealing are much broader and murkier in their scope than the ATAD demands. There are a few reasons for this broadness and murkiness.[908] Firstly, the CITA's legal drafting is getting better but since the CITA became effective at the beginning of 1993, any drafter of new rules is substantially limited by the CITA's awkward terminology. Secondly, the Ministry of Finance of the Czech Republic is considerably understaffed and hybrid mismatches have not been Czech tax policy priority. Thus, there was not room and staff to conduct a thorough implementation analysis.[909] Therefore, the ATAD´s provisions dealing with hybrid transfers, reverse hybrid entities, branch mismatches[910], and the dual residency rule have not been implemented based on rather superficial arguments. The solution to hybrid transfers has not been implemented because it seemed that the Czech Republic has solved this issue by the use of the concept of the beneficial owner. As I have shown above, this statement is false and an amendment to the CITA should be enacted to avoid the infringement of the ATAD by the Czech Republic. The Czech Republic has adopted a similar approach to the reverse hybrid entities. The reasoning behind this decision is that the coordination rule applies in the reverse hybrid situations, but the reverse hybrid can still lead to the double non-taxation outcome. For example, let us have two investors ACo and BCo from EU Member State. These investors establish an entity that is fiscally transparent in the Czech Republic

[904] Section 23h par. 1 of the CITA.
[905] Section 23h par. 2 of the CITA.
[906] Section 23h par. 4 of the CITA.
[907] Section 23h par. 3 of the CITA.
[908] For example, section 23h par. 1 and 2 of the CITA do not limit application of these rules only to hybrid entities and hybrid financial instruments in the broad sense. Thus, the rules could apply to a broader category of different legal treatment situations.
[909] For example, the imported hybrid mismatch rule follows the ATAD in its wording and does not deal with a possible subsidiarity regarding the structured hybrid mismatch, direct hybrid payment, and indirect hybrid payment. However, this is not necessarily wrong from the tax policy perspective but lowers legal certainty of taxpayers.
[910] The provision dealing with the (hybrid) branch mismatches has not been adopted with the explanation that the Czech Republic uses permanent establishment provisions only in double tax treaties which have unified permanent establishment definition. However, this approach omits some other reasons for a mismatch, *e.g.* allocation mismatch. Nonetheless, these issues are outside of the scope of this work.

but the resident EU Member State of ACo and BCo considers the Czech entity as fiscally non-transparent, *e.g.* because the EU Member State uses the fixed approach to foreign entities. The Czech entity than provides a loan to DCo from another country. Thus, if the CFC rules or primary linking rule do not apply, neither the Czech Republic nor the investors' EU Member State tax the income. Then the Czech Republic should make the Czech entity partially fiscally non-transparent according to the ATAD.[911]

To sum up, alas, the CITA does not include all anti-hybrid mismatches rules that should have been implemented. This can lead to infringement of EU law by the Czech Republic[912] because there are situations in which ATAD's rules should apply but they have not been implemented.[913] Thus, since the Czech Republic has not covered all situations which may lead to the use of hybrid entities and hybrid transfers for purposes tax arbitrage, tax planners can still use these measures to lower their overall tax burden. Also, as I have shown above in Chapter 5, linking rules aim to achieve *formal* single taxation. Therefore, it is possible to tax plan around linking rules using deduction / low taxation outcomes until the discussion regarding single taxation is settled. Thus, the easiest way for a tax planner to achieve low taxation is to structure the whole transaction in a way that leads to a deduction plus low single taxation outcome. Tax administration might try challenging this arrangement under the GAAR but it certainly is an uphill battle especially in a situation where it is obvious that the OECD aims for *formal* single taxation anywhere and that the ATAD has follows this approach.

7.4. Summary and Conclusion

I described in this chapter that the implementation of ATAD's anti-hybrid mismatch rules is not flawless and that there are loopholes that the Czech Republic should close to avoid an infringement, in particular, to enact rules to deal with. However, I also discussed that the Czech Republic uses a coordination rule to deal with some situations of hybrid entities and that the Czech Republic thus follows *the home state tax categorization primacy*.

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[911] Article 9a of the ATAD.

[912] A partial transposition is not a correct transposition under EU law. See *e.g.* CJEU, January 14, 2010, C-343/08, *European Commission v Czech Republic*, ECLI:EU:C:2010:14, par. 40-41. The Czech Republic would probably have to argue that these situations cannot in practice arise at all due to interpretation Czech tax law. See *e.g.* CJEU, May 29, 1997, C-300/95, *European Commission v the UK*, ECLI:EU:C:1997:255, par. 37. However, cases of incorrect implementation of directive are appartently inherent to EU law. PRECHAL, Sacha. *Directive in EC Law*. 2nd ed. Oxford: Oxford University Press, 2005, p. 7. ISBN 978-0-19-920759-6.

[913] The clock is ticking because the Commission has already started a process of review of implementation of the ATAD. So far, the Commission has been dealing with interest limitations, CFC rules, and the GAAR but the focus will certainly shift to hybrid mismatches soon. See *e.g.* GOULDER, Robert. Lost in the Shuffle: Is ATAD Producing the Desired Results? *Tax Notes International*. 2020, 2020(August 31, 2020), p. 1247-1248.

8. All's Well That Ends Well: Using Coordination Rules to Tackle Hybrid Mismatches under EU Law

8.1. Introduction

The chapter aims to argue that it is possible to use coordination rule to deal with hybrid mismatches effectively even under the ATAD and the PSD regime because the ATAD constitutes the minimum standard, linking rules in the ATAD apply only in case hybrid mismatch takes place, and linking rules in the PSD apply only to specific D/NI situations. Therefore, the coordination rules are still a valid tax policy option for EU Member States to the extent they prevent hybrid mismatches from appearing or lead at least to *formal* single taxation.

To argue that, I first consider how EU law limits the right to tax regarding income taxation, in particular hybrid mismatches, and how directives must be transposed in the area of direct taxation. Then, I want to show that solution using linking rules sets the minimum standard which allows EU Member States to use other solutions to deal with hybrid mismatches if such solutions lead to single taxation or avoid situations which the ATAD enumerates as hybrid mismatches, *i.e.* prevents different tax characterization or D/NI or DD outcome resulting from hybrid mismatch from arising. However, since I have shown that coordination rules do not always lead to the deterrence of hybrid mismatches, EU Member States still must enact and use linking rules as a solution of last resort under the ATAD/PSD regime.

8.2. EU Law in Direct Taxation and Limitations to Dealing with Hybrid Mismatches

As I discussed in Chapter 2, EU law plays a substantial role in the area of cross-border taxation for EU Member States. Under EU Law, EU Member States are free to establish direct taxation to the extent these rules do not jeopardize the Internal Market, in particular by discriminating individuals or legal persons from other EU Member States. To deal with such situations, primary law contains several provisions that deal with direct taxation. Some of these provisions are self-executing and directly limit EU Member States in their tax policy decisions; other provisions contain specific procedures that can the EU or EU Member States use to design rules dealing with direct taxation affecting the internal market. For instance, the TFEU contains provisions that allow harmonization of laws in direct taxes. The TFEU's essential provision dealing with the harmonization of direct taxes is Article 115 of the TFEU. This article establishes a regime allowing the Council of the EU to enact directives to approximate EU Member States' law in areas directly affecting the Internal Market.

This regime has a few Achilles' heels, though. The solution dealing with direct taxation under Article 115 of the TFEU needs a unanimous vote and permits only using a directive to achieve the

harmonization goal.[914] The former makes negotiations and development more difficult. But this is legitimate since direct taxation is an important part of the EU Member States' tax sovereignty. The latter brings the issue of heterogeneous implementation because every EU Member State can read definitions written in the directive differently and unforeseen mismatches can thus arise.[915] However, EU law contains instruments that can correct some issues.[916]

The beneficial thing about the directives is that they oblige EU Member States to achieve the desired outcome but the means of how EU Member State is going to do it to this state.[917] This is especially significant in the case of the ATAD because the ATAD contains meticulous rules dealing with hybrid mismatches which *prima facie* seem like leaving no room for other than literal transposition to domestic law. However, the ATAD also includes the rule stating that the directive introduces a minimum standard for rules dealing with tax avoidance rules.[918]

To sum up, primary law prohibits discrimination of individuals and legal persons of other EU Member States, the PSD forces EU Member States to deal with one particular cross-border outcome in a specific way (without connecting it to hybrid mismatch) and the ATAD states that if countries use no other rule (besides linking rule), then EU Member States must use linking rules or a specific coordination rule to deal with hybrid mismatches. EU Member States are therefore free to use means preventing hybrid mismatches without discriminating against other EU Member States'

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[914] For the commentary to Article 115 of the TFEU and its limitations see *e.g.* KELLERBAUER, Manuel, Marcus KLAMERT and Jonathan TOMKIN, ed. *The EU Treaties and the Charter of Fundamental Rights*. Oxford: Oxford University Press, 2019, p. 1256-1258. ISBN 9780198794561.

[915] See also GOVIND, Sriram and Stephanie ZOLLES, ref. n. 11, p. 223.

[916] See *e.g.* GOVIND, Sriram and Stephanie ZOLLES, ref. n. 11, p. 240-241. ; HELMINEN, Marjaana, ref. n. 83, p. 54-57.

[917] Article 288 of the TFEU states that "*A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods*". However, for example, Kral writes that this definition is troublesome and needs further clarification. Therefore, he defines a directive as generally not directly applicable act which is primarily addressed to EU Member States for which this act is fully binding, besides some exceptions, as to the result to be achieved and EU Member States have a certain degree to choose form and methods to achieve such result (in Czech "*v zásadě přímo neaplikovatelný unijní akt, který je primárně určen členským státům EU, pro které je, až na výjimky, závazný, pokud jde o výsledek, jehož dosažení tento akt požaduje, s tím, že tyto státy mají určitou volnost volby forem a prostředků dosažení tohoto výsledku*". KRAL, Richard. *EU Directives from the Perspective of Their Transpositions and Domestic Law Outcomes (Směrnice EU z pohledu jejich transpozice a vnitrostátních účinků)*. V Praze: C.H. Beck, 2014, p. 5. ISBN 978-80-7400-282-3. For a detailed discussion on the directive, see *e.g.* KELLERBAUER, Manuel, Marcus KLAMERT and Jonathan TOMKIN, ref. n. 914, p. 1900-1910. ; PRECHAL, Sacha, ref. n. 912, p. 73-76.

[918] However, the department of Czech government responsible for compliance of draft proposals with EU law perceived the ATAD as maximum harmonization stating that the rule enacting minimal standard of the ATAD does not state it clearly and expressed this opinion in a written statement when dealing with a question what part of the transposition constitutes so-called "*gold plating*" or perhaps "*piggybacking*". On the goldplating and piggybacking, see *e.g.* KRAL, Richard, ref. n. 917, p. 101-104. This opinion goes against the ATAD's preamble and Article 3. However, I think it is important to emphasize the fact that even clear drafting can sometimes become confusing even to state officials and that transposition of directives is by no means as easy as it might look like for example for proponents of verbatim transpositions of directives. Nevertheless, the fact that the ATAD constitutes the minimal standard is settled. See *e.g.* GOVIND, Sriram and Stephanie ZOLLES, ref. n. 11, p. 222-223, 241.

nationals as long as this solution (i) prevents the hybrid mismatch from occurring or (ii) leads to the same or stricter taxation of such income as the ATAD requires.[919]

8.3. Coordination Rules as an Addition to the ATAD?

As I showed in Chapter 5, linking rules suffer from several flaws that make their use precarious in practice and legally questionable. Chapter 6 argued that coordination rules can prevent some linking rules' ramifications. Nevertheless, the ATAD uses primarily linking rules approach as opposed to coordination rules originally proposed by the European Commission.[920] So can EU Member States still use coordination rules under the ATAD regime?

Based on the reasoning I have described above, I think that the answer is yes. This applies as long as they fulfill the general criteria I have discussed above. Overall, if coordination rules prevent hybrid mismatches from occurring, an EU Member State does not have to apply linking rules at all. Nonetheless, since I have shown that the use of coordination rules certainly is not flawless either; EU Member States must still enact linking rules in their domestic tax law as an instrument of last resort. Yet, I think that such a combined solution can considerably limit linking rules' flaws.

8.4. Coordination Rules as an Implementation of the ATAD?

Can EU Member State transpose all ATAD's anti-hybrid mismatches provisions by coordination rules and thus avoid the implementation and use of linking rules?

To answer this question correctly, it is necessary to define what a proper implementation[921] of a directive[922] enacting a minimum standard is. The general rule is that it is up to EU Member State to choose the form and methods of the transposition.[923] However, these forms and methods must achieve results stipulated in the directive[924] legally[925] and effectively in reality.[926] The EU Member State also has to consider "*special national circumstances*".[927] As regards Czech tax law, these means must

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[919] On provisions allowing stricter implementation of a directive and limits of such implementation, see *e.g.* KRAL, Richard, ref. n. 917, p. 107-117, 135-137, 143-147.

[920] The only exception is the Article 9a of the ATAD that deals with reverse hybrid entities.

[921] For a general discussion about implementation of a directive, see *e.g.* PRECHAL, Sacha, ref. n. 912, p. 73-91.

[922] Kral states that in general a correct transposition of a directive (i) must be within a given transposition period, (ii) the content of the directive must be properly transposed into law, (iii) the transposition must have a necessary form, and (iv) the transposed measure is enforceable. See KRAL, Richard, ref. n. 917, p. 149.

[923] Article 288 of the TFEU. ; KELLERBAUER, Manuel, Marcus KLAMERT and Jonathan TOMKIN, ref. n. 914, p. 1901-1902.

[924] KRAL, Richard, ref. n. 917, p. 5-6.

[925] See *e.g.* CJEU, January 14, 2010, C-343/08, *European Commission v Czech Republic*, ECLI:EU:C:2010:14. For measures which are not enough, *i.e.* an administrative practice, a general reference, and the settled case law, see KELLERBAUER, Manuel, Marcus KLAMERT and Jonathan TOMKIN, ref. n. 914, p. 1902, par. 23.

[926] "*It follows that Article* (...) *would not have been fully implemented if* (...) *the national legislature had done no more than adopt the necessary legal framework for requiring organizers by law to provide sufficient evidence of security*" CJEU, October 8, 1996, Joined cases C-178/94, C-179/94, C-188/94, C-189/94, and C-190/94, *Dillenkofer and others*, ECLI:EU:C:1996:375, par. 51. See also *ibid*, par. 50. ; KRAL, Richard, ref. n. 917, p. 149-174.

[927] KELLERBAUER, Manuel, Marcus KLAMERT and Jonathan TOMKIN, ref. n. 914, p. 1901, par. 20.

be generally in a statutory form.[928] In practice, the issue is that directives can contain very specific provisions leaving basically no space for divergence. Some academics have expressed an opinion that too detailed provisions leaving no leeway could constitute a breach of Article 288 of the TFEU.[929] However, the CJEU allowed the existence of such a directive in regard to the customs union[930] that belongs within the exclusive competence of the EU.[931] Nonetheless, such strict provision in a directive can also establish a breach of the subsidiarity principle "*in areas which do not fall within its exclusive competence*";[932] direct taxation does not fall within the exclusive competence of the EU.[933] It is therefore necessary to approach transposition of every directive specifically and discuss transposition options in relation to the basis of the directive, its aims, and its provisions.[934]

As regards the ATAD, the directive deals with direct taxation[935], *i.e.* the directive does not fall within the exclusive competence of the EU. The basis for the ATAD's enactment is Article 115 of the TFEU which allows issuing "*directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market*". The ATAD's goals are

- "*ensuring that tax is paid where profits and value are generated*";[936]
- restoration of trust in tax fairness;[937]
- the effective exercise of EU Member States' tax sovereignty;[938] and
- strengthening "*the average level of protection against aggressive tax planning in the internal market*".[939]

The ATAD itself states that its rules should "*be limited to general provisions and leave the implementation to Member States as they are better placed to shape the specific elements of those rules in a way that fits best their corporate tax systems*".[940] Moreover, the ATAD enacts the minimum standard explicitly stating that EU Member States are free to enact stricter anti-tax avoidance rules.[941] These rules show

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[928] See *e.g.* Article 11 par. 5 of the Charter of Fundamental Rights and Freedoms of the Czech Republic stating that "*Taxes and fees shall be levied only on the basis of law*".
[929] KRAL, Richard, ref. n. 917, p. 7.
[930] See CJEU stating that "*it may prove necessary to ensure the absolute identity of those provisions*" in CJEU, November 23, 1977, C-38/77, *Enka*, ECLI:EU:C:1977:190, par. 12, p. 2212.
[931] Article 3(1)(a) of the TEU.
[932] Article 5 of the TEU.
[933] HELMINEN, Marjaana, ref. n. 227, p. 4.
[934] KRAL, Richard, ref. n. 917, p. 75.
[935] Article 1(1) of the ATAD.
[936] Recital 1 of the Preamble to the ATAD I.
[937] Recital 1 of the Preamble to the ATAD I.
[938] Recital 1 of the Preamble to the ATAD I.
[939] Recital 3 of the Preamble to the ATAD I.
[940] Recital 3 of the Preamble to the ATAD I.
[941] Recital 3 of the Preamble to the ATAD I and Article 3 of the ATAD.

general limitations for the transposition of the ATAD.[942] Particular limitations of the ATAD stem from articles 2(9), 9, 9a, and 9b of the ATAD. Article 2(9) of the ATAD defines the scope of situations covered by the ATAD and its linking rules that the ATAD stipulates in Article 9. As I have shown above, the ATAD's linking rules lead to *formal* single taxation and deal only with the downward departure from the single tax principle.

The verbatim transposition of the directive is usually not the only option for transposition,[943] but it sometimes can be, in particular when EU Member State implements a definition.[944] Sometimes EU Member States may prefer verbatim transposition. But in such a scenario, the EU Member State must proceed with an analysis if such transposition is possible[945] and preferable.[946] Nonetheless, the implementation must be precise and clear.[947]

Since the ATAD constitutes the minimum standard and it is possible to prevent some outcomes when linking rules apply, I infer that EU Member States do not have to use only the verbatim transposition of the ATAD as concerns hybrid mismatches. Hence, to the extent, the transposition using coordination rules avoids hybrid mismatches covered by the ATAD, the transposition avoiding linking rules is possible and preferable. Alas, the coordination rules cannot avoid all instances of hybrid mismatches covered by the ATAD. Hence, EU Member States cannot implement the ATAD's anti-hybrid mismatches rules using coordination rules *only*.

To sum up, getting back to the question of whether it is possible to implement ATAD's linking rules using exclusively the coordination rules, the answer is no until it is obvious that coordination rules can prevent all hybrid mismatches covered by the ATAD from occurring. Unfortunately, such implementation is impossible because the coordination rules cannot prevent all hybrid mismatches within the ATAD's scope, *e.g.* imported hybrid mismatches.

However, similarly to what I wrote above, I infer that it is possible to partially implement the ATAD's anti-hybrid mismatches rules by enacting coordination rules to the extent that coordination rules prevent hybrid mismatches from appearing or establish at least *formal* single taxation. In such circumstances, the hybrid mismatches do not occur and the condition for using the linking rule is not fulfilled.

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[942] For the discussion about provisions enacting minimal standards see *e.g.* KRAL, Richard, ref. n. 917, p. 66-67, 114-117.

[943] See CJEU stating that "*the transposition of a directive into domestic law does not necessarily require that its provisions be incorporated formally and verbatim in express, specific legislation*". CJEU, May 30, 1991, C-361/88, *Commission v Germany*, ECLI:EU:C:1991:224, par. 15.

[944] KRAL, Richard, ref. n. 917, p. 77. However, an implementation of EU definitions has its own set of complexities. The problem is that domestic law definitions often need domestic law definitions to stipulate the EU definition. Legislators can avoid this by using specific EU language but this can result into complex and puzzling provisions leading to interpretational issues. See *e.g.* Sections 23a-d of the CITA.

[945] KRAL, Richard, ref. n. 917, p. 77-81.

[946] KRAL, Richard, ref. n. 917, p. 81.

[947] PRECHAL, Sacha, ref. n. 912, p. 76-78.

8.5. ATAD's Direct Effect in the Czech Republic

Directives can have a direct effect under certain circumstances.[948] This effect can apply to various constellations. In general, directives can have the *vertical direct effect* and cannot have the *reverse vertical direct effect* and *horizontal effect*. As I have shown in Chapter 7, the Czech Republic has not fully and effectively dealt with all instances of hybrid mismatches covered by the ATAD's scope. Therefore, on the one hand, corporate taxpayers might use ATAD's direct effect if it is in their benefit and under certain conditions. On the other hand, the Czech Republic cannot try to apply the ATAD directly to tax these hybrid mismatches outcomes. Such a situation would constitute a reverse vertical effect that the CJEU prohibits.[949] Theoretically, the ATAD's GAAR could cover these situations. However, the GAAR is certainly narrower in scope because it needs (i) subjective and (ii) objective conditions for its application. That does not apply to linking rules. Also, linking rules deal only with no-taxation situations. Therefore, countries should not consider *low* taxation using hybrid mismatch arrangements as circumventing the linking rules.

8.6. Summary and Conclusion

To sum up, I think that coordination rules are still a useful instrument to deal with hybrid mismatches even under the ATAD regime. The main aim of the ATAD is to abolish outcomes unwanted from the tax policy perspective, *i.e.* double non-taxation. Linking rules deal with this issue in a complex way but ultimately (at least theoretically) should lead to the desired outcome (single taxation) but so far cannot ensure the *substantial* single taxation. However, the coordination rules solution avoids hybrid mismatches completely in applicable cases. Therefore, it is possible to argue that if EU Member State uses coordination rules, there is no need for linking rules to the extent the use of coordination rules alleviates the undesired outcome of the issue. Nevertheless, the use of coordination rules should not be overstated because unilateral coordination rules have their limits in some cases such as *vis-à-vis* the imported mismatches.

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[948] See *e.g.* KELLERBAUER, Manuel, Marcus KLAMERT and Jonathan TOMKIN, ref. n. 914, p. 1903-1909.

[949] CJEU stating that "*a Member State which has not adopted the implementing measures required by the directive in the prescribed periods may not rely, as against individuals, on its own failure to perform the obligations which the directive entails*". CJEU, April 5, 1979, C-148/78, *Ratti*, ECLI:EU:C:1979:110, par. 21-22. ; CJEU, December 12, 2013, C-425/12, *Portgas*, ECLI:EU:C:2013:829, par. 23.

9. Epilogue: Summary and Conclusions

9.1. Summary: What Was This Dissertation About?

This dissertation had one leading argument. The argument is that coordination rules can lead to better tax policy results than linking rules, which the OECD and the EU have proposed to solve hybrid mismatches arrangements, and that EU Member States can use coordination rules even under the ATAD and the PSD regime if the coordination rule achieves at least formal single taxation. Unfortunately, linking rules bring too many ramifications that tax policymakers may want to avoid. Therefore, I argue for using coordination rules in situations where their use is feasible and using linking rules only as a last-ditch attempt against the outcomes of hybrid mismatches.

To pursue my argument, I have introduced some underlying principles and rules of the international tax arena which (i) can lead to hybrid mismatches and (ii) countries must obey. To avoid possible confusion, I have briefly discussed the differences between tax theory, tax policy and tax law.

Then, I have shown examples of hybrid mismatches, how tax theory, tax policy, and EU tax law currently comprehend these mismatches, and that hybrid mismatches can lead to various outcomes.

To normatively assess these outcomes, I have touched on the discussion dealing with the question of how many times and how much should countries tax a cross-border income. Since current normative answers to these questions are inconclusive, I have concluded that countries are free to structure their own tax policy unless they have a legally binding rule stating otherwise.

However, EU Member States must implement linking rules that the OECD and the EU have proposed as the solution to hybrid mismatches. Hence, I have analyzed where linking rules come from, the OECD BEPS Project Action 2, and what their underlying tax policy aim is, *i.e. formal* single taxation (*no matter where* for the OECD, *ideally within the EU* for the EU).

Since the analysis performed by other scholars and by me has shown that linking rules bring too many legal and factual pitfalls, I have briefly discussed the alternative approaches toward hybrid mismatches. Due to factual and legal constraints of other solutions, *e.g.* withholding taxation and tax term harmonization, I have decided to deal further with coordination rules as a unilateral, but ideally multilateral, solution for states who want to solve hybrid mismatches in a manner that better suits their tax policy and tax design needs. Therefore, I have shown some possible coordination rules that can deal with hybrid entities, debt-equity hybrid financial instruments, and hybrid transfers and discussed the possible impact of coordination rules on these hybrid mismatches.

After the discussion of coordination rules, I have analyzed the Czech implementation of the ATAD and suggested some amendments to the CITA. The last part of my argument then deals with

the possibility of using coordination rules under the ATAD. I base this argument on the reasoning that (i) it is up to EU Member States to find a way to implement the EU directive, (ii) the ATAD contains a "minimum standard" provision which allows EU Member States to come up with stricter anti-avoidance rules, (iii) coordination rules, as I show, lead to the same (or similar) outcome as linking rules, *i.e. formal* single taxation, and (iv) thus, EU Member States must currently use linking rules only under the condition where coordination rules do not protect tax system from hybrid mismatch.

9.2. Answering Research Questions

During the course of my argument, I have come to these answers to the research questions:

1. Q: Why can hybrid mismatches arise? A: Hybrid mismatches can arise because countries structure their international tax rules in mostly uncoordinated manner.
2. Q: What are hybrid mismatches? A: In tax theory, hybrid mismatches are a set of international tax situations where two or more jurisdictions classify one element important for proper taxation differently. In the OECD tax policy the term hybrid mismatch arrangement encompasses situations leading to double non-taxation through a D/NI or DD outcome. In EU tax law, hybrid mismatch includes the list of situations enumerated in EU directives, *i.e.* the PSD and the ATAD, leading to D/NI or DD outcomes.
3. Q: Why do tax policymakers care about hybrid mismatches? A: Tax policymakers are generally free to decide that they do not want to allow their corporate taxpayers to lower their overall tax duty using hybrid mismatch arrangements.
4. Q: What is the tax policy aim of linking rules? A: The tax policy aim of the OECD BEPS Project Action 2 linking rules is strict *formal* single taxation, *i.e.* linking rules care about the fact that deduction or non-inclusion of cross-border income has to be prevented without considering the taxpayer's reasoning behind the transaction, *no matter where*. Thus, these linking rules do not deal with *substantial* single taxation, *i.e.* linking rules do not deal with the statutory or tax rate of taxation of hybrid mismatches. The EU linking rules also follow the *formal* single tax principle but shift from *no matter where* approach to *within the EU* policy.
5. Q: Are linking rules effective in dealing with hybrid mismatches? A: Linking rules are effective in theory by preventing D/NI and DD outcomes but they introduce many practical and legal hurdles which render linking rules costly and ineffective, in particular to countries that have understaffed tax administration with no previous experience with hybrid mismatches.

6. Q: Is it possible to design other solutions tackling the core issue of the hybrid mismatches while having the same or a similar tax policy aim? A: Yes, scholars and tax policymakers have introduced alternative solutions to linking rules that alleviate some problems connected to using these rules. Examples of these solutions are coordination rules, formulary apportionment, and conditional withholding taxation. Coordination rules are effective in preventing some hybrid mismatches from occurring.
7. Q: If there is a better solution to hybrid mismatches, is it possible to implement such solution even though the ATAD uses linking rules for solving hybrid mismatches? A: EU Member States can use coordination rules to deal with hybrid mismatches to the extent that such coordination rules prevent hybrid mismatch from happening or achieves *formal* single taxation.

9.3. The Limitations of My Argument

I have limited the scope of my dissertation so that I could focus more thoroughly on the elements that are most important for my argument. Therefore, there are some limits to this work. Firstly, I have dealt with permanent establishment mismatches only briefly, and I have not suggested any solution, for reasons I described in the introduction. Secondly, I have not discussed the impact of formulary apportionment of the tax base, which could become the new norm of international taxation in the future. However, the path to achieve formulary apportionment approval in the OECD or the EU is still uncertain. Thirdly, I did not deal with some special income tax forms in order to avoid overcomplicating the argument. Fourthly, my analysis of coordination rules is certainly not definitive, but it is only an addition to the debate started by Thuronyi, Parada, and others about the usefulness of coordination rules to deal with hybrid mismatches. Coordination rules certainly need more attention in my future work. Lastly, I acknowledge that my argument regarding possible transposition using *formal* single taxation argument is controversial because EU directives show some preference regarding source taxation in D/NI situations and residence taxation in DD situations. However, the clash between a regular linking rule (the ATAD) and a reverse linking rule (the PSD) show that even the EU does not provide a clear answer about the allocation of taxing rights. In addition, I wanted to support the idea that EU Member States should transpose directives with regard to their effects instead of mindlessly copying the text of a directive.

9.4. Further Research

Possibilities for further research stem from the limitations of my dissertation. Branch mismatches certainly deserve greater attention, especially once there is an international consensus on

how to deal with taxing electronic commerce; this consensus could affect the permanent establishment notion as well as the discussion about formulary apportionment and harmonization of some definitions in tax law. Also, new developments regarding BEAT and GILTI in the US and Pillar 1 and 2 projects in the OECD have shown that some countries take the single tax aim seriously. This fact might enhance the subsequent discussion about the single tax principle. Regarding the discussion about substantial single taxation, it can be useful to deal with the issue of transposing the ATAD's linking rules with the addition of rules applying to situations of deduction and low-taxation. Finally, more discussion about coordination rules and harmonization of tax definitions is necessary in order to ascertain a proper implementation of these measures.

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Teoretické aspekty mezinárodní spolupráce v daňových věcech

Abstrakt

Disertační práce řeší aktuální problém, že v současnosti převládající přístup k hybridním nesouladům v podobě tzv. *linking rules* je z mnoha důvodů neefektivní. Členské státy Evropské unie by tak měly zvážit a přijmout jiná řešení hybridních nesouladů, např. v podobě koordinačních pravidel, aby bylo dosaženo jednoho zdanění přeshraničního příjmu, pokud je to cílem jejich daňové politiky. Smyslem disertační práce je pomoci tvůrcům daňové politiky, aby se mohli lépe vypořádat s hybridními nesoulady a zároveň dosáhli větší právní jistoty a nižších nákladů spojených s aplikací linking rules pro daňové poplatníky i správce daně.

Při řešení tohoto problému se disertační práce dotýká základních aspektů mezinárodního zdanění, popisuje vybrané množiny hybridních nesouladů, řeší důsledky hybridních nesouladů. Disertační práce dále probírá, co jsou linking rules a jaké jsou jejich zásadní nedostatky. Jelikož je těchto nedostatků mnoho, probírá disertační práce další možná řešení hybridních nesouladů a poukazuje na to, že koordinační pravidla mohou být řešením vhodnějším. V rámci následující diskuse disertační práce analyzuje česká pravidla proti hybridním nesouladům transponovaná na základě směrnice ATAD a argumentuje, že členské státy EU mohou v určitých mezích stále používat koordinační pravidla jako řešení hybridních nesouladů i v rámci režimu směrnice ATAD.

Argumentace, kterou v této disertační práci předkládám, vede k několika praktickým a teoretickým závěrům. Ukazuji, že definice některých forem hybridních nesouladů není v literatuře jednotná. Dále poukazuji na to, že cíl daňové politiky za iniciativami akce č. 2 projektu G20 / OECD BEPS a směrnicí ATAD nejsou jedno zdanění v místě, kde dochází ke tvorbě hodnoty, ale pouze formální jedno zdanění, a to „*bez ohledu na to, kde k němu dojde*". Kromě toho řeším, že hybridní nesoulady jsou výsledkem nejednotného zacházení právních předpisů upravujících daně z příjmů s domácími a přeshraničními situacemi. Proto si myslím, že používání koordinačních pravidel je rozumným řešením, které může zabránit vzniku některých případů hybridních nesouladů. Dále jsem popsal, že použití koordinačních pravidel může být proveditelným a výhodnějším řešením, protože linking rules lze obejít v rámci daňového plánování, což může být frustrující pro země, jejichž cílem je dostatečně vysoké zdanění přeshraničních příjmů. Příkladem takové situace může být aplikace GAAR na situace, kdy bude poplatník daně z příjmů obcházet linking rules. V případě, kdy daňový poplatník bude obcházet linking rules pomocí schémat vedoucích k odpočtu se zahrnutím příjmu s nízkým zdaněním, pak není možné GAAR automaticky aplikovat, protože nedochází k porušení účelu linking rules. Na základě předcházející diskuse pak analyzuji implementaci pravidel proti hybridním nesouladům směrnice ATAD do českého zákona o daních z příjmů a identifikuji mezery

a jiné nedostatky v těchto pravidlech. Mimo jiné docházím k závěru, že česká implementace nepokrývá některé situace hybridních převodů a reverzních hybridních entit, na které dopadají pravidla směrnice ATAD. Evropská komise by pak na základě této neúplné transpozice mohla s Českou republikou zahájit řízení o nesplnění povinnosti. V rámci disertační práce také řeším, spíše teoretickou, možnost, jestli linking rules mohou být součástí mezinárodního zvykového práva a docházím k závěru, že v současnosti nikoli, protože nejsou naplněny prvky nezbytné pro vytvoření takového zvyku.

Argumentace disertační práce je omezena předem stanoveným rozsahem a metodikou disertační práce. Co se rámce práce týče, disertační práce se zabývá pouze hybridními entitami, hybridními finančními nástroji a hybridními převody. Disertační práce se naopak, vyjma několika případů, nezabývá nesoulady stálých provozoven, časovými nesoulady a jinými formami nesouladů v přeshraničních situacích. Mimo rámec disertační práce je také řešení pomocí přerozdělovacího mechanismu v rámci harmonizace základu daně z příjmů právnických osob a některé zvláštní formy zacházení s dluhovým a kapitálovým financováním v daních z příjmu. Co se metodiky práce týče, disertační práce využívá především doktrinální diskusi využívající podle potřeby normativní a empirický výzkum na podporu doktrinálních argumentů. Budoucí empirický výzkum týkající se skutečné účinnosti linking rules a koordinačních pravidel by však byl přínosný.

Primárním cílem disertační práce je tedy připojit se k doktrinální diskusi o koncepčních problémech spojených s hybridními nesoulady a ukázat, že akademici by měli při svých diskusích brát v úvahu skutečnost, že daňová politika států může směřovat k jednomu zdanění přeshraničního příjmu.

Klíčová slova:

Hybridní nesoulady; hybridní entity; hybridní finanční nástroje; hybridní převody; linking rules; koordinační pravidla; projekt BEPS; akce 2; ATAD.

Hybrid Mismatches After the ATAD

Theoretical Aspects of International Cooperation in Tax Matters

Abstract

This dissertation argues that the current approach toward hybrid mismatches, *i.e.* linking rules, is ineffective and that EU Member States should consider and adopt other solutions to hybrid mismatches, in particular coordination rules, to achieve single taxation of cross-border income if it is their tax policy goal. I make this argument to help tax policymakers deal properly with hybrid mismatches while also achieving greater legal certainty for taxpayers and tax administrators. While pursuing my claim, I touch on the essential elements of current international taxation, describe certain sets of hybrid mismatches, discuss policy implications of hybrid mismatches' outcomes, and show what linking rules are and that they have many shortcomings. Consequently, I discuss various alternative solutions to hybrid mismatches and point out that coordination rules can be a better method to pursue. Using the preparatory discussion, I examine the Czech anti-hybrid mismatches rules and argue that EU Member States can, to some extent, still use coordination rules as a solution to hybrid mismatches under the ATAD.

My analysis leads to practical and theoretical conclusions. I show that the academic literature does not consistently define some forms of hybrid mismatches, show that the G20/OECD BEPS Project Action 2 and the ATAD's aims are not substantial single taxation based on value creation but only *formal* single taxation "*no matter where*" or in the EU. I also show that hybrid mismatches represent the incoherent treatment of domestic-only and cross-border situations by income tax law. Therefore, I argue that using coordination rules is a reasonable solution that prevents some hybrid mismatches altogether instead of dealing only with their outcomes. Then I show that using coordination rules can be a feasible and even preferable approach because linking rules are easy to tax plan around; this fact can be frustrating for countries if *substantial* single taxation is actually the tax policy aim of a particular EU Member State. Describing the situation of the Czech Republic as a particular EU Member State, I also identify loopholes of the current Czech anti-hybrid mismatches rules. Moreover, I illustrate that the implementation does not cover some situations of hybrid transfers and reverse hybrid entities, and thus the European Commission could begin an infringement procedure against the Czech Republic. Besides, I argue that since the linking rules tax policy goal is not *substantial* single taxation but merely *formal* single taxation, the deduction/low-taxation outcome does not violate linking rules, which is important in case tax administrators want to use the GAAR to deal with such cross-border situations. Finally, I suggest that the international legal custom of taxing hybrid mismatch arrangements once could arise in limited cases, but the arguments for its existence are inconclusive for now.

The dissertation's scope and methodology bound the argument of the dissertation. The dissertation deals only with hybrid entities, debt-equity hybrid financial instruments, and hybrid transfers and does not deal with permanent establishment mismatches, timing mismatches, and other forms of mismatches in cross-border settings; the formulary apportionment solution and some special forms of the income tax treatment of debt and equity are also outside of the dissertation's scope. The dissertation uses primarily doctrinal discussion, using from time to time normative and empirical research to support the doctrinal argument. However, further empirical research about the effectiveness of linking rules and coordination rules in the future would be beneficial. Thus, the dissertation's primary aim is to join the doctrinal discussion about the conceptual issues involved with hybrid mismatches and to show that academics should consider the fact that countries can have single taxation as their tax policy goal in some situations.

Keywords:

Hybrid mismatches; hybrid entities; hybrid financial instruments; hybrid transfers; linking rules; coordination rules; BEPS Project; Action 2; the ATAD.